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Federal Income Tax Treatment of Capital Gains and Losses.

Donald Charles Marshall

Louisiana State University and Agricultural & Mechanical College

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GAINS AND LOSSES.

Louisiana State University, Ph.D., 1967
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FEDERAL INCOME TAX TREATMENT OF CAPITAL
GAINS AND LOSSES

A Dissertation

Submitted to the Graduate Faculty of the
Louisiana State University and
Agricultural and Mechanical College
in Partial Fulfillment of the
Requirements for the Degree of
Doctor of Philosophy

in

The Department of Accounting

By
Donald Charles Marshall
B.B.A., Lamar State College of Technology, 1958
M.S., Louisiana State University, 1964
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ABSTRACT

The taxation of capital gains and losses is a highly controversial subject. The controversy arises over whether or not these gains constitute elements of income; whether or not they should be treated as income for tax purposes; and, if they are to be subject to tax, what approach to taxation should be employed. Contributing to the capital gains problem is the fact that the goals of the tax system are in constant conflict with one another. No method of handling capital gains and losses can provide an equitable treatment for all taxpayers, simplicity in reporting and administration, and the facilitation of social and economic goals. Neither complete exemption, complete inclusion, nor any approach in between can overcome this conflict of goals. The solution to the problem, then, demands compromise and compromise has led to the present dilemma.

The purpose of this study is to arrive at a method of treating capital gains and losses which satisfies each of the goals of the tax system while remaining politically and mechanically practical. In an effort to put the pertinent aspects of the problem in perspective, the study reviews the historical development and the present status of the law (both in the United States and elsewhere), the nature of capital gains and losses, and the various

proposals for reforming the existing law.

The conclusion of the study is that capital gains and losses fall within broad definitions of income and that a substantial portion of them are included even in narrow definitions. With respect to taxpaying capacity and economic function they are undistinguishable from other types of income. Capital gains and losses should be included in full as taxable income at the point of realization and realization should be broadened to include the transfer of capital assets by gift or at death. At the same time the progressive rate structure should be lowered and provisions should be made for a proration of gains and losses over a period equal to the holding period of the asset or five years, whichever is the shorter.

The taxation of income from all sources in the same manner will eliminate the large administrative problem caused by preferential treatment and significantly reduce the complexities of the law. Progression will be restored to capital gains taxation thus facilitating the equitable treatment of all taxpayers. The lowering of the overall rates combined with the elimination of the possibility of postponing or avoiding the tax completely through gifts or at death should minimize the economic interference of the tax. At the same time, the proration provision will

alleviate the problem caused by the "bunching of income."

The approach outlined above is not without opponents but it is entirely feasible from operational and political standpoints. If agreement cannot be reached on this fundamental reform measure, it would still be possible to make worthwhile improvements in the capital gains area. The most urgent step is to provide for the taxation of capital gains at the point of transfer by gift or at death. This relatively simple step would do more to facilitate equity and to eliminate economic interference than any other single move. Indications are that major reform will be slow in coming but that problems created because of the gift and death situation will be eliminated by Congress in the near future.

CHAPTER I

INTRODUCTION

The taxation of gains and losses from transactions involving capital assets presents one of the most prominent and more controversial questions in the field of taxation. The problem has been recognized for half a century during which time numerous writers have explored the area and provided suggestions which were intended to bring about an early solution. In spite of this, in the United States and elsewhere, the history of capital gains taxation is a record of experiment, dissatisfaction, change, and more dissatisfaction. Through the years, capital gains and losses have been dealt with in strikingly different ways and, as indicated by the recommendations of the Johnson Administration, recent actions by Congress and the literature of the field, the present system is still unsatisfactory.

Problems of the Present System

The failure to tax unrealized capital gains and the allowance of indefinite postponement through gift or complete avoidance of the capital gains tax through death result in a major shortcoming of the law; that is, the majority of capital gains are not subject to tax at all. Also due to this shortcoming, gross discriminations arise

between taxpayers who choose to realize their gains and those who prefer to retain appreciated assets. This is particularly true if appreciated assets are held until death. These same provisions (or lack of provisions as the case may be) result in the so-called locked-in effect on investments and the tax avoidance due to reinvested corporate earnings.

Another major problem area under the present capital gains provisions stems from the rate discrimination or preferential treatment extended to long-term capital gains. Since realized net capital gains are heavily concentrated in the hands of higher income taxpayers, preferential treatment creates an inequity in favor of the higher income taxpayers directly at the expense of the lower income taxpayers. The result is that the capital gains tax is actually regressive. Preferential treatment is also responsible for most of the complexities involved in the capital gains law. To provide special treatment for capital gains (as opposed to ordinary types of income) requires distinguishing definitions which are necessarily arbitrary and subject to manipulation. Tremendous amounts of time and energy are spent each year by both the taxpayers and the government due to the incentive provided by preferential treatment; the former in efforts to convert ordinary income into capital gains and the latter in

efforts to prevent the former from being successful.

Other shortcomings of the present law include the discrimination between long-term and short-term gains, the failure to make allowances for the "bunching of income," and the practice of Congress of bestowing capital gain status to taxpayers who press their claims.

Purpose of this Study

This study has as its purpose the exploration of the capital gains problem with a view toward arriving at a conclusion as to whether or not the concept of taxable income should include capital gains and losses, and, if so, the determination of the most suitable method of taxation.

Approach to the Study

In providing a basis for conclusions concerning the handling of capital gains and losses, the study reviews the historical development of the law, the present provisions of the law, and the experiences of other countries with capital gains taxation. Also the nature of capital gains and losses and the various proposals for reforming the law relating thereto are presented.

The historical development of capital gains taxation is necessary in order to secure an understanding of the circumstances under which the capital gains tax

arose; to determine what types of provisions were employed at various times; and, to evaluate the relative success of each system employed. From this study some tentative conclusions may be reached as to the strengths or weaknesses of various approaches, at least in the particular circumstances which were present at the time. Also, since precedents often play an important role in income tax law, the historical review yields some information as to what these precedents are and what course Congress is likely to take in the future. Chapter II deals with the historical development.

A thorough review of the present capital gain and loss provisions is necessary as a point of reference. In discussing the problems of the system or in contrasting the United States' system with those of other countries, for example, a knowledge of the structure of the gain and loss provisions is useful. It should be recognized that the section of the law relating to capital transactions represents one of the most sophisticated approaches to taxation that has ever been devised. This review, presented in Chapter III, provides insight into the intricacies and complexities of the law in this area.

Any effort to develop a sound and constructive method for treating capital gains and losses should include a consideration of other countries and their experiences

in the area. The adage that one should profit by the experiences of others is applicable in this case. Of course, due to the differences in circumstances in other countries it is not possible to draw firm conclusions about the relative merits of a particular system with respect to how it might work in the United States. A satisfactory approach in one country may not be an appropriate solution elsewhere. However, a review of capital gains taxation in other countries is useful even though any conclusions reached must be regarded as tentative. Another important aspect of foreign taxation that provides valuable insight is the trend of the treatment of capital transactions. The study points out the more recent changes in order to determine the type of efforts which are being made by others to derive a satisfactory system. Chapter IV is a review of the handling of capital gains and losses in selected countries.

The study shows the causes of the phenomenon that is defined in the Code as capital gains and losses. It approaches from a theoretical standpoint the underlying sources of the subject which has caused so much controversy. In this way the economic and social effects can be seen and a conclusion reached as to how they should fit into the tax picture. The study also considers the practical aspects and, based on what is theoretically valid and

what is practically expedient, attempts to reach conclusions regarding workable solutions that satisfy, to the extent possible, the goals of our tax system." The theory of capital gains and losses is discussed in Chapter V.

In trying to fit together an attainable solution to the capital gains problem that will combine theory and practice, the various proposals for reforming the law are reviewed in Chapter VI. As indicated earlier, the problem has been explored by numerous students of taxation and the result has been a number of alternative proposals. With the groundwork already laid in previous sections of the study it is possible to evaluate the proposals. The good and bad features of each proposal serve as a guide in deriving a new proposal for the reform of the treatment of capital gains and losses.

In Chapter VII the writer formulates his conclusions on how the troublesome area can best be dealt with. The chapter includes a specific reform proposal and the writer's estimate of the future course for the treatment of capital gains and losses in the United States.

CHAPTER II

HISTORICAL DEVELOPMENT OF CAPITAL GAIN AND LOSS PROVISIONS

Early tax laws in the United States consisted of a few comparatively simple statutes. No specialist was needed to determine "gross income," to subtract a few allowable deductions, and to apply the relatively low tax rates in order to determine the amount of Federal income tax liability. It is common knowledge that the statutes have multiplied and taken on a degree of complexity with which few people are able to cope. Further, there seems to be no end to this process which, if allowed to continue, will preclude American taxpayers and even their advisors from carrying out the annual settlement with the government. Congressmen, practitioners, and academicians with one voice have called for an end to this process of complexity. For various reasons (most are of a political nature) compromise rules over principle and the process continues.

The legislative history of capital gains taxation may be divided into six periods. During the first period, which begins with the enactment of the first income tax law in 1861 and extends through 1872, various acts of Congress were in force. Generally, the laws of this

period made no distinction between "ordinary income" and "capital gains." The tax rates which were applied were the same. However, only gains which arose from the sale of real estate which had been purchased in the same year were taxed. The forty-year period from 1872 up to and including 1912 saw the individual completely escape any form of income taxation. Corporate income including capital gains was taxed beginning in 1909. The primary reason for this extended period with no income tax was a Supreme Court decision in 1895 which declared the income tax unconstitutional. The third period extends from 1913, the year the structure for our modern tax law was introduced, through 1921. During this period, capital gains of all types were taxed the same as income from any other source. The handling of capital losses changed several times in this interval. The fourth period began with the first attempt to delineate "ordinary income" from "capital gains." This started with the taxable year 1922 and continued until 1934. Here a maximum rate of 12.5 per cent was applied to long-term transactions. Short-term transactions were taxed as ordinary income and capital loss policy continued to vary. The fifth period, which applied to the taxable years from 1934 to 1938 inaugurated a plan whereby capital gains and losses were to be included as ordinary income at a specified percentage based on the

holding period of the various assets involved. Capital losses in these years were deductible to the extent of capital gains plus \$2,000. The sixth and final period, which began with the Revenue Act of 1938 and is basically unchanged today, provides for taking gains and losses into account on a percentage basis with the application of an alternative maximum flat rate. Policy with respect to capital losses has fluctuated widely in this latest period. Capital losses have been severely restricted at one point and allowed liberally at another.

First Period: 1861-1872

The first proposal to levy a federal income tax was made in January, 1815, by Secretary of the Treasury Dallas.¹ It was made under pressure created by the War of 1812 and, according to Professor Seligman, had the war lasted a few months longer, our first income tax would date back to 1815. As it was, the war ended and the need for internal taxes was eliminated. As a result the whole revenue system was abolished.² Not until the

¹American State Papers, vol. VI (Washington: Gales and Seaton, 1832), p. 887. In his report to the Committee on Ways and Means, Secretary of the Treasury Dallas enumerated several proposals for increasing revenues. He concluded by saying "An income tax may be easily made to produce \$3,000,000."

²Edwin R. A. Seligman, The Income Tax (New York: The Macmillan Company, 1911), p. 430.

financial burden of the Civil War did Congress see fit to impose an income tax. The first became effective in 1862; this was 73 years after the adoption of the Constitution.

The Act of August 5, 1861 provided for an income tax of 3 per cent on all incomes of over \$800, after deducting all federal, state and local taxes. The tax was to be levied on income for the year closing December 31, 1861, and was to be paid on or before June 30, 1862.³ Due to the opposition of Secretary of the Treasury Chase (he took no steps to collect the tax) and since the bill as passed was inadequate for the revenue needs, Congress repealed the 1861 Act before any collections were made. It was replaced with the Act of July 1, 1862 which gained the distinction of being the first federal income tax law to go into effect.

The 1862 Act placed a duty of 3 per cent on incomes up to \$10,000, \$600 to be exempted in all cases. Special rates applied to American citizens residing abroad and to income derived from securities of the United States Government. Deductions allowable were national, state, and local taxes paid during the year and all gains, profits, or incomes derived from manufactured articles

³Act of August 5, 1861, 12 Stat. 309-10.

upon which stamp or ad valorem duties were levied.⁴ This last deduction was repealed in 1863 since it would have meant an exemption for all business incomes which were derived from dealings in manufactured articles.⁵ The tax under this Act was to be levied for the taxable years ending 1862 through 1866.

Congress did not intend these acts to spell out the letter of the law. Rather, they vested in the newly created position of Commissioner of Internal Revenue the authority to prepare instructions and regulations needed to carry out the law.⁶ It was through a ruling of the Commissioner that the law was interpreted to include "gains or profits realized from the sale of property during the year 1862, which property was purchased before the excise law went into effect, shall be returned as income for the year 1862."⁷ Little care or discussion was connected with the income tax aspects of the Act (probably because it represented a very minor portion of the total from a revenue standpoint); thus it is not known whether

⁴Act of July 1, 1862, 12 Stat. 474.

⁵Act of March 3, 1863, 12 Stat. 718.

⁶Act of July 1, 1862, 12 Stat. 432.

⁷Decisions Published by Office of Internal Revenue to January, 1871 (Washington: Office of Internal Revenue, 1871), p. 59.

or not Congress originally intended to include capital gains. Neither the law nor the regulations had contained specific reference to capital gains and losses, though the language of the Act was obviously broad enough to include them.

Congress expressed its dissatisfaction with the turn of events in the Revenue Act of 1864. Here it was provided that gains and losses from sales of real estate should be taken into account only when realized from property which had been acquired within the preceding year. This time Congress clarified its intention by expressly including in "annual gains, profits, or income" to be subject to tax "all income or gains derived from the purchase and sale of stocks or other property, real or personal . . ."⁸ In 1867 the law was expanded to include gains from real estate acquired during the two preceding years.⁹ The Revenue Act of 1870¹⁰ carried the same definition of income as the 1867 Act. It was the last of the income tax laws necessitated by the Civil War. The 1870 Act expired in 1872.

During the period 1862 through 1872 capital gains

⁸ Act of June 30, 1864, 13 Stat. 223.

⁹ Act of March 2, 1867, 14 Stat. 471-87.

¹⁰ Revenue Act of 1870, 16 Stat. 256-62.

were taxed in the same manner as income from other sources. The only preferential treatment was the exemption of gains from property which had been acquired more than two years prior to its sale and the exemption of gains from personal property. The rates applicable to these gains varied from a low of 3 per cent under the 1862 Act to a high of 10 per cent under the Acts of 1864 and 1867. It is interesting to note that one author observed about the income taxes of this period that "the law would have operated more justly if a difference in rates had been made between incomes from labor and incomes from invested capital."¹¹ This observation was made in 1914 prior to any preferential rate treatment by any federal income tax. Another point of interest in this period revolved around an area that is still a current problem, that is, whether the tax on capital gains should apply to realized gains only or should be broadly interpreted to include all gains, whether realized or unrealized. One historian points out that treatment by the Internal Revenue Service in the earliest years is not clear. However, due to the wording of the 1867 Act, it is apparent that an attempt had been made to tax unrealized gains in some areas. The law required the

¹¹Harry E. Smith, The United States Federal Internal Tax History From 1861 to 1871 (New York: Houghton Mifflin Company, 1914), p. 97.

farmer to report only the income realized from sales of livestock and not that from the increased value of the livestock, whether sold or unsold.¹²

Second Period: 1873-1912

A period of almost two decades intervened before circumstances arose which caused Congress to revert to an income tax. When President Cleveland included an income tax in his revenue proposal to Congress in December, 1893 a great debate began. In the case of the Civil War acts an emergency was at hand and very little debate was necessary for Congress to make its decisions. Now the same urgency for a revenue measure was not present and the bill was discussed heatedly on the floor of the Senate for six days. With the help of a number of amendments from the Senate the bill became law on August 28, 1894.

The income tax portions of the Act of August 28, 1894 were copied, with a few important exceptions, almost word for word from the tax laws of the Civil War period. The tax was to apply to net income in excess of \$4,000. Income included profits realized from the sale of real estate when the real estate had been purchased within the two previous years. Again gains relating to sales

¹²Sidney Ratner, American Taxation (New York: W. W. Norton & Company, Inc., 1942), p. 116.

of personal property were excluded from the definition of income.¹³

When the time came for the enforcement of the 1894 law, comprehensive preparations were made by the Internal Revenue Service and offices for the collection of the tax were opened in the principal cities. But scarcely had the declarations of income begun to be made when the tax was attacked as unconstitutional, and within a short time it was declared invalid by the Supreme Court.¹⁴ In the Pollock v. Farmers' Loan and Trust Company¹⁵ decision the court held the act unconstitutional on the ground that the tax was a direct tax which could be valid only if apportioned among the states in proportion to population.

Interest in the income tax continued after the Supreme Court decision. Its proponents included President Roosevelt in 1908, when he recommended to Congress the passage of a direct income and inheritance tax.¹⁶ Senator Taft also strongly favored the income tax but felt that

¹³Act of August 28, 1894, 28 Stat. 553-69.

¹⁴Seligman, op. cit., p. 529.

¹⁵157 U. S. 429, 15 Sup. Ct. 673 (1895); 158 U. S. 601, 15 Sup. Ct. 912 (1895).

¹⁶Theodore Roosevelt, Presidential Addresses, vol. 7 (New York: Collier Company, 1910), pp. 1597-1638.

it would not be valid without a constitutional amendment.¹⁷ As a substitute for the general income tax, Congress passed the Corporation Excise Tax Act of 1909.¹⁸ This Act was presented in the form of an amendment to the Tariff Act of 1909 and is unusual because it was first introduced in the Senate. The law was drawn with special care to bring it within the protective coloration of an 1895 Supreme Court decision which had upheld an excise tax.¹⁹ Thus Congress accommodated itself to the high court's decision, at least so far as corporations were concerned, by imposing a tax on the privilege of doing business in the corporate form. The amount of the tax was to be 1 per cent of the net income in excess of \$5,000. Net income was to be ascertained by deducting from gross income all ordinary and necessary operating expenses, losses sustained during the year, all taxes and dividends from stock of taxable corporations.²⁰

This law was held to be constitutional in 1911²¹ and in another decision relating to the Act, the Supreme

¹⁷ Archie Butt, Taft and Roosevelt, vol. 1 (Garden City, N. J.: Doubleday Doran and Company, 1930), p. 134.

¹⁸ Act of August 5, 1909, 36 Stat. 112.

¹⁹ Spreckles Sugar Refining Co. v. McClain, 192 U. S. 397 (1904).

²⁰ Tariff Act of 1909, 36 Stat. 113-118.

²¹ Flint v. Steve-Tracy Company, 220 U. S. 107 (1911).

Court upheld the inclusion of realized gains derived from appreciation of property values as part of taxable income.²² As in earlier acts, Congress left the wording of the law broad enough to include capital gains and losses in taxable income, but was not specific. The high court decision was required to make it clear that capital gains and losses were taxable under the 1909 Act. This corporate excise tax applied to taxable years 1909 to 1912 and the first two months of 1913. The need for it ceased with the adoption of the Sixteenth Amendment and the passage of the Revenue Act of October 3, 1913 which provided for a general income tax to be applied to income received or accrued from March 1, 1913.

Third Period: 1913-1921

The intention of Congress in proposing the Sixteenth Amendment was to confer upon itself the power to tax incomes from whatever source derived. Final action came on July 12, 1909 in the form of a resolution: "Article XVI. The Congress shall have power to lay and collect taxes on incomes, from whatever sources derived, without apportionment among the several states and without regard to any

²²Doyle v. Mitchell Brothers Company, 247 U. S. 179 (1918).

census or enumeration."²³ Ratification of the amendment was not complete until February, 1913. During the first two months of 1913 eight states ratified the amendment. This made a total of forty-two or six more than the three-fourths majority required by Article V of the Constitution. On February 25, 1913, Secretary of State Knox certified that the Sixteenth Amendment had become a part of the Constitution.²⁴

Our present series of income tax laws begins with the first act passed, the Tariff Act of October 3, 1913,²⁵ which included provisions for an income tax. This act repealed the corporation excise tax law as of February 28, 1913 and provided that income received thereafter would be taxed under the new law.

The 1913 Act levied a normal tax of 1 per cent on the taxable income of every citizen of the United States. An additional surtax with graduated rates was levied on the amount of taxable net income over \$20,000. The surtax rates ranged from 1 per cent for taxable incomes from \$20,000 to \$50,000 to 6 per cent on all taxable income

²³Congressional Record, 61st Cong., 1st Sess., 1909, vol. 44, p. 3900.

²⁴Ratner, op. cit., pp. 306-7.

²⁵38 Stat. 114-202.

over \$500,000. The tax applied to individuals as well as corporations except that individuals were provided personal exemptions and corporations were not subject to the surtax. Net income as defined in the Act has been essentially the same in all of the subsequent acts. The following paragraph is taken from this Act:

That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation, or personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits, and income derived from any source whatever.²⁶

Gains, profits or income derived from sale or dealings in property whether the property was real or personal were specifically included in net taxable income. In the same section a general provision was made for the deduction of losses "incurred in trade" but no provision was made for losses incurred outside of the "in trade" definition. The result was that the Treasury treated all profits from sale of property the same as income derived from any other source, (that is, they were subject to the same tax rates and were allowed no special exemption or

²⁶Ibid., 167.

exclusion).

In the discussion of the bill the problem of capital gains and losses, particularly as involved in the sale of real estate and securities, came up for only slight discussion. The author of the bill, Representative Cordell Hull, gave assurance that the bill would apply only to purchases and sales made within the same year.²⁷ The bill as passed made no mention of this and it is not clear as to how the Treasury Department handled this matter. However, the 1916 Act seems to have clarified the issue by requiring that the basis for determination of the amount of gain or loss for property acquired prior to March 1, 1913 would be the fair market value as of March 1, 1913. This indicates that the practice was to tax capital gains regardless of the holding period.

Just as each of the preceding income tax laws were tested in the courts, the 1913 law was challenged. The law was declared constitutional by the Supreme Court in January, 1916, in the case of Brushaber v. Union Pacific Railroad Company.²⁸

The Revenue Act of 1916 had as its principal aim

²⁷Congressional Record, 63rd Cong., 1st Sess., 1913, vol. 50, p. 513.

²⁸240 U. S. 1 (1916).

the raising of revenues in order to prepare for World War I. This was accomplished primarily by the increasing of the tax rates for individuals and corporations. Since there was no distinction between capital gains and ordinary income this meant an increase in the tax rates applicable to capital gains. It also included a number of technical changes that were required because of inequities created under the 1913 Act. One change was to liberalize the treatment of losses from capital transactions entered into for a profit but not connected with a trade or business. The 1916 Act made these losses deductible but in an amount "not exceeding the profits arising therefrom."²⁹ At this point, profits derived from casual type investments, not connected with trade or business were fully taxable; losses of the same type were deductible but only to the extent of gains.

The demands of World War I required significant increases in the income tax rates but did not alter the provisions relating to capital gains. The burden of the war debt continued to be heavy and the Revenue Act of 1918 raised the tax rates to the highest level up to that time. This Act further liberalized the deductions for capital losses. It provided that all losses incurred in any

²⁹Revenue Act of 1916, 39 Stat. 759.

transaction entered into for a profit were deductible, even though they exceeded the amount of the capital gains.³⁰ It also marked the beginning of our present-day loss carry-back and carry-forward provisions.

Fourth Period: 1922-1933

For the first time since the enactment of the modern income tax law in 1913, capital gains were given special treatment under the Revenue Act of 1921. The capital gain provision was originally designed to save from the prohibitive surtaxes profits of individuals derived from the sale of capital assets representing an increment in value over a period of two or more years.³¹ Although the wording of the law was not specific and the intent of Congress was to the contrary (as indicated by the Committee Reported cited in footnote 31), the Treasury had held that a capital gain should be taxed in its entirety in the year of sale. This treatment was called for regardless of the length of the holding period or the period of time over which the gain accrued. Arguments were presented to the effect that this ruling had prevented many sales and thus had deprived the government of

³⁰Revenue Act of 1918, 40 Stat. 1067.

³¹Report of the Committee on Ways and Means, House Report No. 350, 67th Cong., 1st Sess. (Washington: United States Government Printing Office, 1921), p. 10.

revenues.³² In an effort to correct this situation Congress introduced the capital gains clause and for the first time defined the term "capital assets." Included in the definition was "property acquired and held by the taxpayer for profit on investment for more than two years (whether or not connected with his trade or business)" but not "property held for personal use or consumption of the taxpayer or his family, or stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year."³³

The Act divided gains from capital transactions into two categories, the first consisting of gains from assets held for more than two years, and the second of gains from assets held for two years or less. The second category, referred to as "short-term" gains, were to be taxed in full at the normal and surtax rates. Short-term losses were to be deducted in full in computing net income. The special treatment was reserved for the first category or gains from "long-term" transactions. The net of the long-term transactions, if a gain, could be taxed at a rate of 12 1/2 per cent instead of the higher

³²Ratner, op. cit., p. 408.

³³Revenue Act of 1921, 42 Stat. 233.

surtaxes that would apply in the higher brackets. The taxpayer making this election, however, could in no case pay a tax of less than 12 1/2 per cent of his total net income. The Act provided that a net loss from long-term transactions could be fully deducted against ordinary income.

Since the corporate tax rate was to be at the 12 1/2 per cent level at the time when this law was to go into effect, there was no point in providing special treatment for corporations. Consequently, the special capital gains provisions were made inapplicable to them.³⁴ Corporate capital gains continued to be taxed as ordinary income with capital losses treated as a deduction from ordinary income.

Several other significant changes relating to capital gains and losses came about in the 1921 Act. First, in an effort to prevent the evasion of income tax by gifts of appreciated property, it was provided that the basis for determining gain or loss in the case of property acquired by gift after December 31, 1920 was to be the same as the basis of the property in the hands of the donor. Prior to this, the Treasury had ruled that the basis to the donee was fair market value at the date of gift. The result was that the capital gains tax could be

³⁴Ibid.

avoided where appreciated property was transferred in the form of a gift. Second, certain exchanges pursuant to corporate reorganizations were exempted from tax.

The opportunity for tax avoidance created by the 1921 legislation in allowing unlimited deductions for net capital losses was obvious to many. As early as 1922 an amendment was proposed to limit the loss deductions.³⁵ Congress took no action on this until 1924. The Revenue Act of 1924, a major tax reduction act, included several technical changes relating to capital gains and losses. Section 208(c) limited the amount by which tax could be reduced by capital losses to 12 1/2 per cent of such losses (12 1/2 per cent was the maximum tax rate applicable to capital gains at that time). It also removed the stipulation that in no case could the total tax be less than 12 1/2 per cent of total taxable income.

The 1924 Act included the first change in the definition of capital assets as set out in the 1921 Act. This has proved to be the beginning of a long series of changes in this definition. The definition [Section 208(a)(8)] no longer required that assets must have been acquired

³⁵ Report of the Committee on Ways and Means, House Report No. 1388, 67th Cong., 4th Sess. (Washington: United States Government Printing Office, 1923), p. 2.

for a profit or investment. It eliminated the exclusion of "property held for personal use or consumption of the taxpayer of his family." The Senate Finance Committee indicated that this definitional change was primarily to allow taxpayers selling residential property to be taxed under the capital gains section.³⁶

Other important capital gains provisions of the 1924 Act had to do with the alteration of the carry-forward provisions and the prevention of the use of reorganizations to attain a "stepped-up basis" for purposes of depreciation or for calculation of gains and losses in case of sale or distribution of the assets.

The Revenue Act of 1926, which further reduced the tax rates applicable to individuals and increased the corporate rate from 12 1/2 per cent to 13 1/2 per cent, contained only minor changes in the provisions for treatment of capital gains and losses. It is interesting to note here that, since the inception of the 12 1/2 per cent maximum rate for capital gains in 1921, the tax rates applicable to individuals had been steadily reduced.³⁷

³⁶Report of the Committee on Finance, Senate Report No. 398, 68th Cong., 1st Sess. (Washington: United States Government Printing Office, 1924), p. 22.

³⁷Rate reductions were made in 1924 and 1926. From 1921 to 1926 the maximum combined normal and surtax was reduced by more than 50 per cent.

No corresponding change had been made in the capital gains rate. As one might surmise and, as writers of the period indicate, there was a great deal of pressure for a reduction in the capital gains rate. However, no action was taken in this direction.

The only bearing the 1928 legislation had on capital gains and losses was an indirect one relating to corporations. The corporate tax rate was lowered from 13 1/2 per cent to 12 per cent and, since there was at that time no special treatment for capital gains and losses of corporations, this meant a reduction in the rates applicable to corporate capital transactions.

The decreases in Federal revenues occasioned by the Great Depression and the lack of corresponding decreases in Federal expenditures brought about the Revenue Act of 1932. The rates applicable to both individual and corporate taxpayers were increased and several technical changes were made in an effort to bolster tax revenues.

The collapse of security prices had yielded large amounts of deductible losses which seriously contributed to the depletion of the Federal tax revenues. The Ways and Means Committee indicated that "many taxpayers had been completely or partially eliminating from tax their income from salaries, dividends, rents, etc., by deducting

therefrom losses sustained in stock and bond markets with serious effect upon the revenue."³⁸ Thus the 1932 Act included provisions to further restrict the deducting of losses on the sale of capital assets in arriving at net taxable income. The restriction applied only to short-term transactions involving stocks and bonds. Losses arising from the sale or exchange of securities which had been held two years or less were to be deductible "only to the extent of the gains from such sales or exchanges."³⁹ Since the limitation applied to corporate as well as individual taxpayers, this marked the first time that any special treatment of capital gains and losses had been applied to corporations. The Act did provide that losses which were disallowed in one year due to this restriction could be carried over as an offset against gains from such sales in the following year (this carryover was to be limited to the amount of taxable income in the year the loss was disallowed).⁴⁰ However, the carryover provision never became operative; it was repealed by the National Industrial Recovery Act of 1933.

³⁸Report of the Committee on Ways and Means, House Report No. 708, 72nd Cong., 1st Sess. (Washington: United States Government Printing Office, 1932), pp. 12-13.

³⁹Revenue Act of 1932, 47 Stat. 183.

⁴⁰Ibid.

Fifth Period: 1934-1938

The Revenue Act of 1934 introduced a new method for treatment of the capital gains and losses of individuals. This method gauged the tax liability to the holding period of the assets. The change was brought about by the recommendations of a Joint Committee on Internal Revenue Taxation published in 1933.⁴¹ The Committee considered the capital gains area to be a major problem. The main criticisms of the existing method were that the benefits to be derived were available to a very small group of taxpayers with very high taxable incomes and that the law failed to differentiate among gains derived from assets held for different lengths of time. The report suggested a plan for complete revision which Congress adopted with some modification.

The Act as passed included a new Section 117 entitled "Capital gains and losses." Under this section gains and losses of individuals from the sale of capital assets were to be recognized according to the following percentages:

⁴¹"Prevention of Tax Avoidance," House Committee Print, 73rd Cong., 2nd Sess. (1933).

Period assets held	Percentages of gain included in ordinary income
1 year or less	100
over 1 year but not over 2 years	80
over 2 years but not over 5 years	60
over 5 years but not over 10 years	40
over 10 years	30

Capital gains computed in this way were to be included in other net income and taxed at the full normal and surtax rates. Capital losses were allowed as an offset against capital gains of the same tax year; in addition, \$2,000 of the net capital loss in any one year could be offset against ordinary income. As was true under the 1932 Act, the capital loss provisions applied to corporations as well as individuals, but the special treatment of capital gains was limited to individuals.⁴²

The Revenue Act of 1936 continued the principle of including a percentage of taxable capital gains in income, the provisions being identical with those in the 1934 Act. The 1937 Act carried identical provisions with one addition under Title III - Disallowed Deductions. Here the sections defining losses from sales or exchanges of property were enlarged so as to disallow losses between:

⁴²Revenue Act of 1934, 48 Stat. 714-5.

members of a family; an individual and a corporation, more than 50 per cent of the stock of which was owned by the individual; two corporations, more than 50 per cent of the value of the outstanding stock of which is owned by the same individual; and, certain fiduciary relationships.

Sixth Period: 1938 to Present

As was the case with the 1934 Act, the rather significant changes made in 1938 were brought about by the recommendations of a subcommittee of the Ways and Means Committee. Its report was submitted in January, 1938.⁴³ Although Congress did not follow the Committee's plan for reform too closely, the changes that resulted were directed at the major problems which the Committee pointed out. Important changes were made in the treatment of individual capital gains and losses in order to meet objections raised under the existing law due to the high rates and sharp annual reductions of percentages of gain taxable.⁴⁴

⁴³"Proposed Revision of the Revenue Laws, January 14, 1938" Hearings Before the Committee on Ways and Means, 75th Cong., 3rd Sess. (Washington: United States Government Printing Office, 1938), pp. 9-99.

⁴⁴Ibid., pp. 40-41.

Short-term capital gains were redefined as profits from the sale of capital assets with a holding period of not more than 18 months and were taxable in full at the regular normal and surtax rates. Short-term capital losses were allowable only to the extent of short-term capital gains; however, a one year carryover provision was made for a net short-term capital loss. Long-term capital gains were broken into two categories. For assets with a holding period of more than 18 months but not more than 24 months, $66 \frac{2}{3}$ per cent of the gains was to be recognized. For assets with a holding period of more than 24 months, 50 per cent of the gain was to be recognized. At the same time an alternative method of determining the tax on long-term gains was introduced. This gave the taxpayer the option of including a net long-term gain, determined on the basis of the appropriate percentages, with other income subject to the normal and surtax rates or of having the net gain taxed separately at a flat rate of 30 per cent. The taxpayer could choose the method which would yield the lowest tax liability. When the percentage inclusion and the maximum flat rate were taken into account the result was a maximum effective rate of 20 per cent (30 per cent times $66 \frac{2}{3}$ per cent) for assets with a holding period of over 18 but not over 24 months, and 15 per cent (30 per cent times 50 per cent) for gains on assets with a holding period of over 24

months.

Thus the 1938 approach was a combination of the 1934 percentage inclusion method and the pre-1934 flat-rate tax method. In a fashion similar to the gains provision, net long-term capital losses, determined on the basis of the appropriate percentage, could either be deducted from other income or considered separately with 30 per cent of the allowable loss applying as a credit against the tax liability computed on the basis of other income. The method which applied was to be the one which yielded the greater tax liability. There were no provisions for the carryover of the non-deductible portion of a long-term capital loss.⁴⁵

The provisions described above applied solely to individuals. Capital gains of corporations were still treated as income from any other source and taxed at the regular rates (maximum rate was 19 per cent in 1938-39). Capital losses of corporations were deductible to the extent of capital gains. In addition, \$2,000 of net capital loss could be used as an offset against other income. The restriction on the deductibility of corporate capital losses worked a hardship on many corporations due to the effects of the Great Depression. The Report of

⁴⁵Revenue Act of 1938, 52 Stat. 501-2.

the Committee on Ways and Means pointed out the need for a relief provision and stressed the advantages that would accrue to the taxpayer if he were able to offset against ordinary income the full amount of losses from sales of depreciable property.⁴⁶ In order to accomplish this objective a change was made in the definition of capital assets. Depreciable property used in trade or business was excluded from the category of property constituting capital assets.⁴⁷ This meant that gains on dispositions of depreciable property would be subject to tax as ordinary income, but at the same time, such losses (which were much more prominent than gains during this period) would be fully deductible in the computation of net taxable income.

As was indicated in the Report of the Committee on Ways and Means, the 1938 change which took depreciable property out of the capital asset category became a source of irritation for many corporations.⁴⁸ The unfortunate

⁴⁶ Report of the Committee on Ways and Means, House Report No. 1860, 75th Cong., 3rd Sess. (Washington: United States Government Printing Office, 1938), pp. 6-7.

⁴⁷ Revenue Act of 1938, 52 Stat. 500.

⁴⁸ Report of the Committee on Ways and Means, House Report No. 855, 76th Cong., 1st Sess. (Washington: United States Government Printing Office, 1939), p. 11.

result was that buildings and other depreciable real property were excluded from capital assets but land remained in the capital asset category. These classifications necessitated an allocation of sales proceeds between the improvements and the land. The Revenue Act of 1939⁴⁹ circumvented this problem by making a distinction between short-term (held less than 18 months) and long-term (held 18 months or more) losses of corporations. Net long-term losses were to be allowable in full as an offset against ordinary income. Short-term losses were to be handled in the same way as individuals; that is, they were available as offsets against short-term gains with a provision for a one year carryover (limited to the amount of net income in the year of the net short-term loss).⁵⁰ The Act made no change in the treatment of the capital gains and losses of individuals or in the handling of capital gains of corporations. Both long- and short-term capital gains of corporations continued to be treated as

⁴⁹The Revenue Act of 1939 consolidated and codified the internal revenue laws of the United States. The result was titled the Internal Revenue Code. Acts subsequent to the Revenue Act of 1939 (and prior to the 1954 Code) constituted amendments to the 1939 Code. In 1954 the internal revenue laws were revised again and amendments since that time apply to the 1954 Code.

⁵⁰Revenue Act of 1939, 53 Stat. 52 adding Int. Rev. Code of 1939, Sec. 117(d).

ordinary income subject to the regular tax rates.

A change in the definition of capital assets was made by the Revenue Act of 1941. Federal, state or local obligations issued after March 1, 1941, on a discount basis, and payable without interest at a fixed maturity date not exceeding one year from the date of issue were excluded from the category of capital assets. The amendment was necessary in order to eliminate the requirement of having to make an allocation between the interest and capital gain or loss when the obligation was disposed of.⁵¹

The first changes in the income tax brought about by World War II were incorporated in the Revenue Act of 1942. The Act was designed to add revenues by increasing sharply the individual and corporate rates and by broadening the tax base. Material changes in the capital gain and loss provisions were also made. The changes were within the pattern adopted by the 1938 Act, but they were considered to be radical at that time. The holding period was shortened from 18 months to 6 months with a moderate increase in the maximum applicable rate, and a limitation was made in the extent to which capital losses could be offset against ordinary income.⁵²

⁵¹Revenue Act of 1941, 55 Stat. 698 amending Int. Rev. Code of 1939, Sec. 117(a)(1).

⁵²Revenue Act of 1942, 56 Stat. 843-6 amending Int. Rev. Code of 1939, Sec. 117.

Perhaps the most debated issue in the 1942 legislation was the holding period for long-term gains. Proposals ranged from the elimination of the distinction between short- and long-term altogether⁵³ to a six-month holding period. The Ways and Means Committee drew the line between short- and long-term at 15 months.⁵⁴ The Senate Finance Committee advocated lowering the holding period to six months in order to encourage the realization of capital gains and thereby create added revenues. Also the Committee felt that a holding period of six months would be sufficient to deter the speculator as contrasted with the legitimate investor.⁵⁵

The 1942 Act made both long- and short-term capital losses allowable against both long- and short-term capital gains and the privilege of taking long-term capital losses as a deduction against ordinary income was discontinued (except to the extent of \$1,000 per year allowed to individuals). The carryover privilege for the capital

⁵³Report of the Committee on Ways and Means, House Report No. 7378, 77th Cong., 2nd Sess. (Washington: United States Government Printing Office, 1942), p. 1187.

⁵⁴Report of the Committee on Ways and Means, House Report No. 2333, 77th Cong., 2nd Sess. (Washington: United States Government Printing Office, 1942), pp. 30-1.

⁵⁵Report of the Committee on Finance, Senate Report No. 1631, 77th Cong., 2nd Sess. (Washington: United States Government Printing Office, 1942), p. 50.

losses of individuals was set at five years. Corporations were also given the privilege of a five year carryover but the losses carried over could be offset only against subsequent capital gains.⁵⁶

Due to the high level of corporate tax rates, Congress provided an alternative tax computation for corporations similar to that provided for individuals under the 1938 Act. Also, in keeping with the increase in the surtax rates for individuals, the alternative flat rate for individuals was increased from a maximum of 30 per cent (effectively 15 per cent) to 50 per cent (effectively 25 per cent). The alternative method for corporations provided an applicable rate of 25 per cent but the effective ceiling for both types of taxpayers was 25 per cent.⁵⁷

The 1938 Act, as noted above, had excluded "depreciable property used in the trade or business" from the category of capital assets. The 1942 Act went further and excluded from the definition real property used in the trade or business.⁵⁸ The need for such a change was

⁵⁶Revenue Act of 1942, 56 Stat. 844 amending Int. Rev. Code of 1939, Secs. 117(d) and (e).

⁵⁷Revenue Act of 1942, 56 Stat. 843 amending Int. Rev. Code of 1939, Secs. 117(b) and (c).

⁵⁸Revenue Act of 1942, 56 Stat. 846 amending Int. Rev. Code of 1939, Sec. 117(a).

discussed in the Report of the Ways and Means Committee. Its purpose was to provide the same treatment for buildings, improvements and land so as to eliminate the allocation of capital gain or loss between the improvements and the land.⁵⁹ After these assets were taken out of the capital asset definition Congress went further and enacted a new Section 117(j) to provide special benefits to such property. The new section permitted gains upon sales or exchanges of property used in trade of business (held for more than six months) and recognized gains from compulsory or involuntary conversion of long-term assets to be treated as capital gains, but losses (to the extent they exceed capital gains) should be treated as ordinary losses.⁶⁰

The approach to the taxing of capital gains and losses which was adopted in the 1938 Act and transformed somewhat by the 1942 Act has remained essentially the same. However, numerous revisions have been enacted into the framework of the 1942 taxing method. These revisions have primarily been in the area of the definition of capital assets, the method of offsetting capital gains and losses,

⁵⁹ Report of the Committee on Ways and Means, House Report No. 2333, 77th Cong., 2nd Sess. (Washington: United States Government Printing Office, 1942), pp. 52-3.

⁶⁰ Revenue Act of 1942, 56 Stat. 846 adding Int. Rev. Code of 1939, Sec. 117(j).

and the so-called "recapture of depreciation." In the following discussion the changes which have general application will be reviewed; the remaining changes, while large in number, seem to be quite limited in their application and interest and therefore will only be mentioned briefly.

The Revenue Act of 1943 extended provisions similar to those provided for depreciable and real property used in the trade or business to dealings in timber. That is, there was an opportunity extended for limiting the tax when a capital gain was involved while a net capital loss resulted in an ordinary loss.⁶¹

Copyrights and literary, musical, or artistic compositions in the hands of the creator or one taking from the creator with his basis were excluded from the definition of capital assets.⁶² In addition, Section 117(m) was added to the Code⁶³ in an effort to close a significant loophole involving so-called "collapsible corporations." The collapsible corporation was described as "a device whereby one or more individuals attempt to convert the

⁶¹Revenue Act of 1943, 58 Stat. 46 adding Int. Rev. Code of 1939, Sec. 117(k).

⁶²Revenue Act of 1950, 64 Stat. 932-3 amending Int. Rev. Code of 1939, Sec. 117(a)(1).

⁶³Revenue Act of 1950, 64 Stat. 934-6.

profits from their participation in a project from income taxable at ordinary rates to long-term capital gain taxable only at a rate of 25 per cent."⁶⁴ Under the new provisions gain from the sale or exchange of stock in collapsible corporations became taxable as ordinary income if (a) the stockholder owned 10 per cent or more of the stock, (b) more than 70 per cent of the gain on the stock was attributable to the property produced by the corporation, and (c) the gain was realized within three years after the property was produced. The definition of collapsible corporations was set out in detail at Section 117(m)(2).

The special treatment described above which was afforded timber under the 1943 Act was extended by the Revenue Act of 1951 to coal royalties,⁶⁵ livestock,⁶⁶ and unharvested crops.⁶⁷ Thus under certain circumstances capital gains from these items were taxed at the preferential

⁶⁴Report of the Committee on Finance, Senate Report No. 2375, 81st Cong. 2nd Sess. (Washington: United States Government Printing Office, 1952), pp. 88-91.

⁶⁵Revenue Act of 1951, 65 Stat. 501 amending Int. Rev. Code of 1939, Sec. 117(k)(2).

⁶⁶Revenue Act of 1951, 65 Stat. 501 amending Int. Rev. Code of 1939, Sec. 117(j)(1).

⁶⁷Revenue Act of 1951, 65 Stat. 500 adding Int. Rev. Code of 1939, Sec. 117(j)(3).

rates while a net capital loss could be offset against ordinary income. Section 329(a) of the 1951 Act set out for the first time the conditions under which termination pay received by an employee could be treated as being received in the sale or exchange of a capital asset.⁶⁸ The Act also provided that "capital gains" created by sales or exchanges between certain related taxpayers would be given ordinary income treatment.⁶⁹ A provision of the 1951 Act which was widely applicable had to do with the elimination of the two-for-one offset of short-term capital losses against long-term capital gains. Prior to this time, an individual taxpayer reduced his long-term capital gain or loss by 50 per cent in determining the net capital gain or loss. At the same time 100 per cent of the short-term capital losses were taken into account. The result was that one dollar of short-term capital loss served to offset two dollars of long-term capital gain. This change was accomplished by modifying the method of determining the alternative tax.⁷⁰ Last but certainly not least, the

⁶⁸Revenue Act of 1951, 65 Stat. 504-5 adding Int. Rev. Code of 1939, Sec. 117(p).

⁶⁹Revenue Act of 1951, 65 Stat. 504 adding Int. Rev. Code of 1939, Sec. 117(o).

⁷⁰Revenue Act of 1951, 65 Stat. 499 amending Int. Rev. Code of 1939, Sec. 117(c)(2).

1951 Act increased the income tax rates. Corporate rates were raised to a new high (total rate of 52 per cent compared to the former 47 per cent). Also, the maximum tax on capital gains went up from 25 per cent to 26 per cent for corporations as well as individuals. The effective dates for this increase were April 1, 1951 for corporations and November 1, 1951 for individuals. The capital gains rate increases had a termination date of April 1, 1954.⁷¹

Although the Internal Revenue Code of 1954 retained the same method for determining capital gains and losses and for computing tax liability as was applicable under the amended 1939 Code, it involved numerous changes. These changes mainly dealt with the opportunity for obtaining capital gain or loss treatment for certain types of assets. Under certain conditions capital gains treatment was extended to profits derived from the disposition of patents,⁷² the sale or exchange of options if the option was a capital asset in the hands of the holder,⁷³ and gains on the sale of subdivided real estate where the taxpayer is not classified as a dealer.⁷⁴ An exclusion

⁷¹Revenue Act of 1951, 65 Stat. 465, 471.

⁷²Int. Rev. Code of 1954, Sec. 1235.

⁷³Int. Rev. Code of 1954, Sec. 1234.

⁷⁴Int. Rev. Code of 1954, Sec. 1237.

from the category of capital assets was made with respect to accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or for inventory.⁷⁵ Several "loophole-closing" provisions were added to prevent conversion of ordinary income into capital gain through the use of short sales⁷⁶ and, with respect to original issue discount, through the redemption or retirement of bonds or other evidences of indebtedness.⁷⁷ For the purpose of clarification, Section 1223 was added to the 1954 Code; it dealt with holding periods.

The major income tax changes in 1958 were embodied in the Technical Amendments Act of 1958. As indicated by the use of the word "technical" in the title of the act, many of the changes were merely corrections in language and other similar technical changes of very limited effect. The impact of the Act on the treatment of capital gains and losses was comparatively small.

The 1958 Act makes provision for deductibility as an ordinary loss rather than as a capital loss the losses on the sale, exchange, or worthlessness of a narrow class

⁷⁵Int. Rev. Code of 1954, Sec. 1221(4).

⁷⁶Int. Rev. Code of 1954, Sec. 1233.

⁷⁷Int. Rev. Code of 1954, Sec. 1232.

of stock which is referred to as "small business stock."⁷⁸ The type of stock which qualifies is defined in detail at Section 1244(2). Only individuals could avail themselves of the special treatment and Section 1244(d) provides certain limitations to the amount of ordinary loss that can be taken. The obvious purpose of the new legislation was to encourage investment in certain small businesses.

Provisions relating to the treatment of bonds issued at a discount⁷⁹ and short sales⁸⁰ were further tightened by the 1958 Act in an effort to prevent the conversion of ordinary income into capital gain.

The opportunities to depreciate property for tax purposes at a rate which exceeds the actual economic depreciation are quite apparent. This is particularly true since the 1954 Code introduced as acceptable certain accelerated methods for computing depreciation. President Kennedy recognized this when in 1961 he stated:

Another flaw which should be corrected at this time relates to the taxation of gains on the sale of depreciable business property. Such gains are

⁷⁸Technical Amendments Act of 1958, 72 Stat. 1645-6 adding Int. Rev. Code of 1954, Secs. 1242 and 1243. Also, Small Business Tax Revision Act of 1958, 72 Stat. 1676-8 adding Int. Rev. Code of 1954, Sec. 1244.

⁷⁹Technical Amendments Act of 1958, 72 Stat. 1642 amending Int. Rev. Code of 1954, Sec. 1233(a) (2) (A).

⁸⁰Technical Amendments Act of 1958, 72 Stat. 1643-4 amending Int. Rev. Code of 1954, Sec. 1233.

now taxed at the preferential rate applicable to capital gains, even though they represent ordinary income. . . .⁸¹

The Senate Finance Committee in considering a bill to remedy the situation indicated "The taxpayer who has taken excessive depreciation deductions and then sells an asset, therefore, in effect, converted ordinary income into a capital gain."⁸²

President Kennedy recommended that "capital gains treatment be withdrawn from gains on disposition of depreciable property, both personal and real property, to the extent that depreciation has been deducted for such property by the seller in previous years, permitting only the sales price over the original cost to be treated as capital gain."⁸³ This recommendation was implemented with important modification with the Revenue Acts of 1962 and 1964.

Section 1245⁸⁴ provides generally, that gain from

⁸¹"Special Message to the Congress on Taxation, April 20, 1961," Public Papers of the Presidents of the United States - John F. Kennedy, 1961 (Washington: United States Government Printing Office, 1962), p. 299.

⁸²Report of the Committee on Finance, Senate Report No. 1881, 87th Cong., 2nd Sess. (Washington: United States Government Printing Office, 1963), p. 95.

⁸³"Special Message to the Congress on Taxation, April 20, 1961," op. cit.

⁸⁴Added to Int. Rev. Code of 1954 by the Revenue Act of 1962, 76 Stat. 1032-6.

any disposition of depreciable personal property (excluding livestock) during a taxable year beginning after December 31, 1962, is to be taxed as ordinary income to the extent that it resulted from depreciation deductions allowed after December 31, 1961. Important also was the provision that this type of gain would be taxable "notwithstanding any other provision" of the Internal Revenue Code.⁸⁵ The section includes a detailed definition of "Section 1245 property" and provides special handling for transfers by gift, bequest, pursuant to tax-free exchanges, or to a charitable organization.

This problem as it related to depreciable real property was not attacked by the 1962 Act since it was excluded from the definition of section 1245 property. The Revenue Act of 1964 included a "recapture" provision that was concerned with depreciable real property. This provision was much less stringent than the one related to personal property which was described above.

The 1964 statute added Section 1250 to the Code.⁸⁶ This section generally provides that any gain on depreciable real property disposed of after December 31, 1963 to the

⁸⁵Revenue Act of 1962, 76 Stat. 1033 adding Int. Rev. Code of 1954, Sec. 1244.

⁸⁶Revenue Act of 1964, 78 Stat. 100-5 adding Int. Rev. Code of 1954, Sec. 1250.

extent the gain was created by depreciation deductions (greater than those that would have been allowable under the straight-line method) allowed after December 31, 1963, will be taxed as ordinary income. The amount to be "recaptured" as ordinary income will decline over a 10-year holding period so that no ordinary income will result from the disposition of real estate with a holding period of more than 10 years. This section also applies notwithstanding any other provision of the Code.⁸⁷ As in the case of Section 1245, special provisions were made for gifts, transfers at death and certain nontaxable transactions.

Also, effective for taxable years beginning after 1963, the capital loss carryover provision for individuals was liberalized. Prior to this revision individuals were allowed to carry a net capital loss over for five years. The carry-forward loss was applied first against net short-term capital gain, then against net long-term capital gain, and last against ordinary income to the extent of \$1,000 per year (\$2,000 per year on a joint return). The 1964 Act gives individuals an unlimited carryover period but carryover losses are to be treated as long- or

⁸⁷ Revenue Act of 1964, 78 Stat. 105 adding Int. Rev. Code of 1954, Sec. 1250(h).

short-term depending on whether they were long- or short-term in the year they were incurred.⁸⁸

⁸⁸Revenue Act of 1964, 78 Stat. 99-100 amending Int. Rev. Code of 1954, Sec. 1212(b)(1).

CHAPTER III

REVIEW OF THE PRESENT LAW

This chapter attempts, as concisely as possible, to present in meaningful form the major provisions of the law dealing with capital gains and losses. It is not within the purpose of the presentation to be complete and exhaustive; rather the purpose is to bring out the highlights. It is necessary to define and explain certain terms at the outset since they will be referred to later.

Definition of Terms

Capital Assets. The Code defines capital assets by stating what they are not. It has been left to students of the law and the courts to make positive statements relating to what capital assets are. Section 1221 is the sole definitive statement in the Code:

For purposes of this subtitle, the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include-

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation

provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, or similar property, held by-

(A) a taxpayer whose personal efforts created such property, or

(B) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property;

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1); or

(5) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.¹

Any property which is not included in the above exceptions constitutes a capital asset. After elimination of non-capital assets, the principal types of capital assets are stocks and bonds held by an investor and personal assets such as a residence or an automobile. Whether or not property falls into the capital asset category depends

¹Int. Rev. Code of 1954, Sec. 1221.

solely on the type of property and the purpose for which it is held.

In connection with capital assets as well as the other terms defined herein, it should be noted that numerous tedious but important questions arise concerning the specific interpretation of such concepts as "property held by the taxpayer for sale to customers" or "property used in his trade or business, of a character which is subject to the allowance for depreciation." Such detailed handling is outside the scope of this paper. Clarification of these fine points can often be obtained by reference to the Federal Income Tax Regulations, the Treasury Department rulings of various types, and the precedent of decisions in the courts.

Section 1231 Assets. Property which is included in the definition of Section 1231 Assets is comprised of a group of assets which may be treated as capital assets. This provision is a special concession in favor of taxpayers since it treats some net gains (excess of losses of a similar nature) as if they were capital gains. At the same time, if net losses exceed net gains, the taxpayer receives ordinary loss treatment. The items included in the Section 1231 category are:²

²Int. Rev. Code of 1954, Sec. 1231.

- (1) Property used in a trade or business on which depreciation is allowable;
- (2) Real property used in a trade or business and not held regularly for sale to customers;
- (3) Cut timber on which a taxpayer has elected to report the gain at the time of cutting;
- (4) Coal and timber royalties;
- (5) Unharvested crops sold with land if the land has been held for more than 6 months;
- (6) Livestock held by a taxpayer for draft, breeding or dairy purposes, for 12 months or more (but not poultry);
- (7) Compulsory or involuntary conversion of any of the items (1) to (6) above (not including loss or condemnation of completely uninsured business property);
- (8) Compulsory or involuntary conversion of capital assets (not including loss or condemnation of completely uninsured income-producing property) held for more than 6 months.

With the exception of unharvested crops (item 5 above) and livestock (item 6 above), assets in these categories must have a holding period of more than 6 months in order to qualify for this special treatment. Cut timber (item 3 above) is the only asset for which Section 1231 is elective. In determining the net gain or loss from Section 1231, transactions involving the other items listed must be taken into account. The largest component of property in this category of assets is depreciable property used in trade or business with a holding period of more than 6 months.

Ordinary Assets. The term "ordinary assets" does not appear in the Code. However, simple deduction indicates that all property falls into one of two categories; that is, property that receives some special treatment where gains and losses are involved and property that receives no special treatment. Capital assets and Section 1231 assets encompass the special treatment category. Thus assets which are neither Capital assets or Section 1231 assets receive no special treatment and shall be herein referred to as ordinary assets. A negative statement defining these assets can be derived from Section 1221 and 1231. These sections define assets which receive special treatment. Any property specifically excluded from both of these sections falls into the ordinary asset category.

Both sections specifically exclude inventories, stock in trade, and property held for re-sale to customers.³ These items constitute the greater portion of ordinary-type assets. In addition, the capital asset definition excludes all depreciable and real property used in the trade or business. On the other hand, the definition of Section 1231 property includes all depreciable

³Int. Rev. Code of 1954, Secs. 1221(1) and 1231(b)(1) A and B.

and real property used in the trade or business if held over 6 months. The result is that no special treatment is afforded depreciable or real property used in the trade or business which is held for 6 months or less. Thus this latter property falls into the category of ordinary assets.

Sale or Exchange. Whether or not an asset disposed of was sold or exchanged is important since Sections 1222 and 1231 indicate that special treatment for gains and losses is afforded only to assets disposed of through a sale or exchange. Thus special treatment of a gain or loss may depend on whether or not a sale or exchange took place. This needs further explanation since the terms as used by the Code are not synonymous with the definitions conventionally used by businessmen. Most, but not all, conventional sales or exchanges are treated as such by the Code. Problems often arise when a transaction is complicated so that its form is misleading. Businessmen often refer to transactions in terms of form or appearance. On the other hand, the Code generally ignores the form of a transaction and is based upon its substance. An example would be a formal leasing arrangement which in substance constitutes a sale.

Other transactions are included where a sale or

exchange is definitely not involved but the transactions are somewhat similar to a sale or exchange in their effect. Examples include the event of a security becoming worthless,⁴ the retirement of bonds,⁵ the involuntary conversion at a gain of Section 1231 Assets or Capital Assets (holding period must be over 6 months),⁶ and the cutting of timber under certain conditions.⁷ Involuntary conversions to which the Code refers are those that result in "the destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof."⁸ In order to meet the definition, the property must be converted into money or other property.

Holding Period. The importance of the length of the holding period is signified by the fact that this period determines in part whether or not an asset comes under the statutory definition of Section 1231 and it determines whether a gain or loss on the disposition of a

⁴Int. Rev. Code of 1954, Sec. 165.

⁵Int. Rev. Code of 1954, Sec. 1232(a).

⁶Int. Rev. Code of 1954, Sec. 1231(a).

⁷Int. Rev. Code of 1954, Sec. 631(a).

⁸Int. Rev. Code of 1954, Sec. 1231(a).

capital asset is to be of the short- or long-term variety. Thus preferential treatment is dependent on the holding period. Since preferential and ordinary treatment are substantially different in terms of impact on tax liability, it is important to establish the exact holding period of property.

The holding period is computed by excluding the day on which the asset was acquired and including the day on which it was disposed of.⁹ When dealing with securities bought and sold through a stock exchange it is the trade date that becomes the acquisition or disposition date. This is true regardless of when delivery or settlement is carried out.¹⁰ The Code¹¹ makes provision for a number of special cases where holding period does not follow conventional form. Special rules apply to property transferred by the gift or at death, property acquired in a non-taxable exchange, the acquisition of a new residence replacing an old residence, and certain options to buy or sell property.

Recapture Depreciation. So-called "recapture depreciation" is important since it constitutes the major

⁹Int. Rev. Code of 1954, Sec. 1223.

¹⁰IT 3705, CB 1945, p. 174.

¹¹Int. Rev. Code of 1954, Sec. 1223.

exception to preferential treatment that may otherwise be obtained from the disposition of Section 1231 Assets. Property meeting all criteria for special treatment under Section 1231 may, as a result of the recapture provisions, be treated as ordinary gain or loss for tax purposes.

Sections 1245 and 1250 (the recapture sections) are designed to prevent the conversion of ordinary income into capital gain through depreciation deductions. Since the reduction in basis of property as a result of depreciation deductions is often responsible for the creation of capital gains, these sections have as their purpose the taxation of the portion of the gain created by depreciation deductions as ordinary income. Prior to the Revenue Act of 1962 when the first of these provisions were made part of the law, the disposition of a Section 1231 Asset at a gain could only result in preferentially treated income, long-term capital gain. Section 1245 applies to depreciable property used in the trade or business except for livestock, buildings and their structural components. Gains on Section 1245 property disposed of during a taxable year beginning after December 31, 1962 to the extent of depreciation deductions taken after December 31, 1961 are treated as ordinary income. The recapture provisions are modified in the case of gifts, transfers at death, certain tax-free transactions, and involuntary conversions.

Section 1250 applies to dispositions of depreciable real property (including leaseholds) after December 31, 1963. The depreciation deductions subject to recapture are those allowed subsequent to December 31, 1963. Only the amount of depreciation taken in excess of what would have been allowed on the straight-line method is subject to recapture. In addition, the amount to be recaptured declines over a 10-year period (an asset with a holding period of over 10 years is not subject to recapture under Section 1250). Only a percentage of the excess depreciation is taken into account as ordinary income. The applicable percentage means 100 per cent minus one percentage point for each month that the property was held over 20 full months. The only situation where 100 per cent of the excess depreciation is recaptured is where an asset has been held for 20 full months or less; in this situation the applicable percentage is 100 per cent. As in the case of Section 1245, special cases arise when Section 1250 property is disposed of through gift, transfer at death, or involuntary conversion, or certain tax free exchanges.

Adjusted Basis. The gain or loss realized on a sale, exchange, or other disposition of property is the difference between the "amount realized" and the "adjusted

basis" of the property.¹² In a number of situations which will be mentioned later in this chapter, the realized gain or loss is not recognized. However, the amount of gain or loss realized when property is disposed of is an important computation which must always be made. Basis considerations constitute one of the most involved areas relating to capital gains and losses. However, a great deal of the complexity is concerned with numerous exceptional type situations, so that in a brief handling the majority of cases will be covered.

The Code defines adjusted basis as basis¹³ after taking into account certain adjustments.¹⁴ Basis may be cost to the taxpayer, fair market value at time of acquisition, adjusted basis of the property in the hands of the donor (substituted basis), fair market value at optional valuation date in the case of property acquired from a decedent, or adjusted basis in the hands of the transferor when property is received in a nontaxable exchange (substituted basis). The most general situation is where the taxpayer acquires property through an outright purchase

¹²Int. Rev. Code of 1954, Sec. 1001(a).

¹³Int. Rev. Code of 1954, Sec. 1011.

¹⁴Int. Rev. Code of 1954, Sec. 1016.

or constructs or develops the property himself. When property is purchased, the basis is cost, which generally includes total consideration paid for the property plus commissions and other expenses incurred in connection with the purchase. In the case of property which is constructed or developed by the taxpayer, cost may include payments for construction made to outsiders or to the taxpayer's regular employees (and to which must be added overhead costs which may be allocable to the construction).

Adjusted basis is determined by applying certain additions and reductions to the basis (unadjusted) beginning with the acquisition date (or other basic date in the case of substituted basis) and ending with the disposition date. The specific adjustments allowed are defined in Section 1016. The basis in property is generally increased for investment of capital and decreased for recoveries of capital. Items properly chargeable to the capital account are defined as follows:

The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, including the cost of improvements and betterments made to the property. No adjustment shall be made in respect of any item which, under any applicable provision of law or regulation, is treated as an item not properly chargeable to capital account but is allowable as a deduction in computing net or taxable income for the taxable year.¹⁵

¹⁵Fed. Inc. Tax Reg., Sec. 1.10162(a).

A downward adjustment is required, according to the Regulations, as quoted below:

the cost or other basis of property shall be decreased for exhaustion, wear and tear, obsolescence, amortization, and depletion by the greater of the following two amounts: (a) the amount allowed as deductions in computing taxable income to the extent resulting in a reduction of the taxpayer's income taxes, or (b) the amount allowable for the years involved.¹⁶

The adjusted basis of property is important not only from the standpoint of determination of gain or loss but it also controls the amount of depreciation or depletion which is allowable. As stated in a Tax Court Memorandum Decision, the purpose of the Code provisions regarding basis is to provide for a return of capital tax free.¹⁷

Alternative Tax. In situations where a taxpayer's capital transactions result in a net gain and the gain is due to an excess of net long-term gain over net short-term loss, the excess is subject to a maximum tax rate.¹⁸ The effect of the alternative tax provision is to provide relief from the higher tax rates applicable to ordinary types of income. Under the present tax rate structure the provision is beneficial only in situations where taxable

¹⁶Fed. Inc. Tax Reg., Sec. 1.1016.3(a)(1).

¹⁷V. F. Bond, 24 P-H Tax Ct. Memo. 144 (1955).

¹⁸Int. Rev. Code of 1954, Sec. 1201.

income exceeds \$26,000 on a separate return or \$52,000 on a joint return.

In the regular computation tax is determined for taxable income. Taxable income will have already been relieved of one-half of the excess of net long-term capital gain over net short-term capital loss through the long-term capital gains deduction. In the alternative computation tax is determined for taxable income less the remaining one-half of the excess of net long-term capital gain over net short-term capital loss. In effect a partial tax is determined for taxable income ignoring capital transactions. To this partial tax is added 25 per cent of the excess of net long-term gain over net short-term loss. The computation which yields the lower tax is applicable.

The alternative computation for a corporate taxpayer is slightly different but the effect is the same, the maximum applicable tax to the excess net long-term gain is 25 per cent.

Amount Realized. In general, the amount realized by a taxpayer when property is sold, exchanged or otherwise disposed of consists of the total consideration received less expenses connected with the disposition. Consideration in the case of a sale usually consists of cash, notes, and the assumption of obligations of the taxpayer. Where

exchanges are concerned, the consideration often includes, in addition to or in lieu of the above, the value of other property or benefits received in the transfer.

Business Property. A non-business asset (for example, a personal residence) may qualify as a capital asset; however, in the event the asset is disposed of at a loss, a deductible loss does not result. This is true even though a gain resulting from the disposition of the same asset would be subject to tax. Thus with regard to capital assets it is necessary to distinguish between those "losses incurred in a trade or business" or "losses incurred in any transaction entered into for a profit, though not connected with a trade or business."¹⁹ If property does not fall into one of these categories, loss on disposition of the property can only be obtained if the disposition qualifies as a casualty loss of theft.

A trade or business has been defined as a regular occupation or calling of the taxpayer engaged in as a livelihood or for a profit.²⁰ Profit has been defined as "the advantage or gain resulting from the investment of capital, or the acquisition of money beyond the amount

¹⁹Int. Rev. Code of 1954, Secs. 165(c)(1) and (2).

²⁰Schwinn, 9 BTA 1304 (1928).

expended; a pecuniary gain."²¹

Casualty Loss or Theft. Section 165(C)(3) indicates that an individual taxpayer may deduct losses not compensated for by insurance even though the "losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft." A "casualty" is an event due to some sudden, unexpected or unusual cause.²² Deduction for allowable casualty losses or thefts of non-business property are deductible only to the extent that the amount of the loss from each casualty and each theft exceeds \$100.²³

Losses on property used in trade or business or of capital assets held for more than 6 months (Section 1231 Assets) which resulted from casualty or theft, if the property was not covered by insurance, are ordinary rather than Section 1231 losses.²⁴ This is true even though the net of Section 1231 transaction results in a gain. Thus it is not necessary to offset long-term capital gains with losses from casualty or theft.

²¹Goldsborough v. Burnett, 46 F. 2d, 432 (CCA-4, 1931).

²²Shearer v. Anderson, 16 F. 2d, 995 (CCA-2, 1927).

²³Int. Rev. Code of 1954, Sec. 165(c)(3).

²⁴Int. Rev. Code of 1954, Sec. 165(a).

Capital Loss Carryover. Certain limitations apply to the deduction of net capital losses.²⁵ In the case of a corporate taxpayer no provision is made to deduct a net capital loss from ordinary income; the capital loss is allowed only to the extent of recognized gain from capital transactions. However, provisions are made to carryover such losses to future tax years.²⁶ A corporation can, subject to a number of restrictions, carryover a net capital loss to each of the five succeeding tax years. Regardless of the original nature of the loss it is treated as a short-term capital loss in each of the carry-over years.

The provisions regarding non-corporate taxpayers are somewhat more lenient. If a net capital loss results, the taxpayer can offset the loss against net income to the extent of \$1,000, provided that taxable income is at least \$1,000. If taxable income is less than \$1,000 the deduction is limited to taxable income. Further, the non-corporate taxpayer has the privilege of carrying over unused capital losses for an indefinite period. It should be noted, however, that the carryover loss retains its original nature,

²⁵Int. Rev. Code of 1954, Sec. 1211.

²⁶Int. Rev. Code of 1954, Sec. 1212.

that is, if it was short-term in the year incurred it must be treated as short-term in each year to which it is carried. The same is true of long-term losses.

Other Terms. The definition of other necessary terms can be taken directly from the Code:²⁷

(1) Short-term capital gain. - The term 'short-term capital gain' means gain from the sale or exchange of a capital asset held for not more than 6 months, if and to the extent such gain is taken into account in computing gross income.

(2) Short-term capital loss. - The term 'short-term capital loss' means loss from the sale or exchange of a capital asset held for not more than 6 months, if and to the extent that such loss is taken into account in computing taxable income.

(3) Long-term capital gain. - The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income.

(4) Long-term capital loss. - The term 'long-term capital loss' means loss from the sale or exchange of a capital asset held for more than 6 months, if and to the extent that such loss is taken into account in computing taxable income.

(5) Net short-term capital gain. - The term 'net short-term capital gain' means the excess of short-term capital gains for the taxable year over the short-term capital losses for such year.

(6) Net short-term capital loss. - The term 'net short-term capital loss' means the excess of short-term capital losses for the taxable year over the short-term capital gains for such year.

²⁷ Int. Rev. Code of 1954, Sec. 1222.

(7) Net long-term capital gain. - The term 'net long-term capital gain' means the excess of long-term capital gains for the taxable year over the long-term capital losses for such year.

(8) Net long-term capital loss. - The term 'net long-term capital loss' means the excess of long-term capital losses for the taxable year over the long-term capital gains for such year.

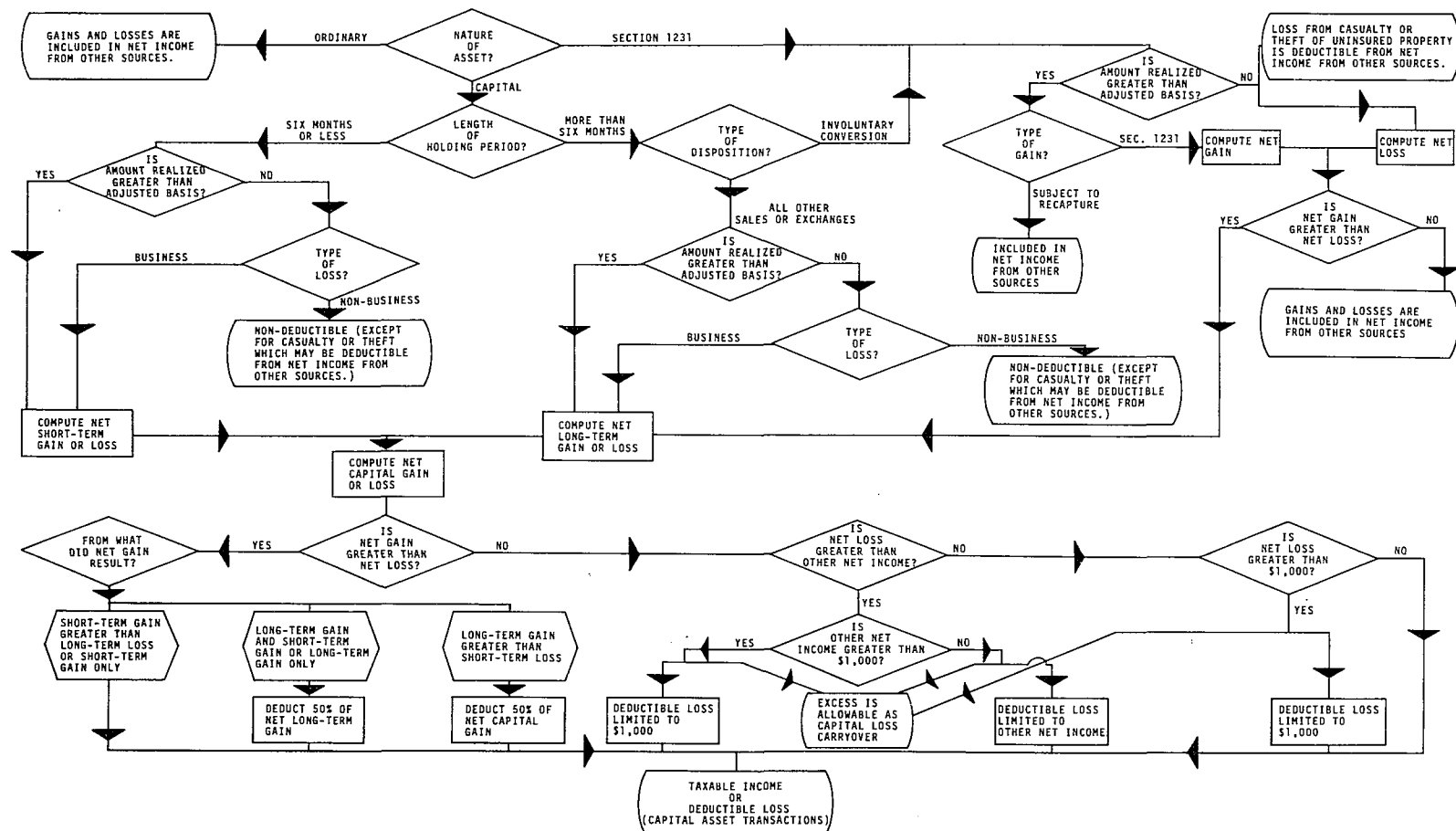
(9) Net capital gain. - In the case of a corporation, the term 'net capital gain' means the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges.

(10) Net capital loss. - The term 'net capital loss' means the excess of the losses from sales or of capital assets over the sum allowed under section 1211. In the case of a corporation, for the purpose of determining losses under this paragraph, amounts which are short-term capital losses under section 1212 shall be excluded.

Tax Computation

The accompanying diagram shows the steps necessary to determine the amount of gain or loss subject to tax from dispositions of assets for the majority of cases. The concern here is primarily to determine the capital gain or loss. In a number of circumstances the diagram shows gain or loss to be included in net income from other sources. This is mainly a convenience in flow charting the capital gain and loss provisions but it has the advantage of showing the relationships between capital gains and losses and income from other sources. The provisions diagrammed apply to a non-corporate taxpayer; however,

FLOW CHART SHOWING THE COMPUTATION OF TAXABLE INCOME
OR DEDUCTIBLE LOSS ON DISPOSITIONS OF ASSETS



with minor modification, the diagram can be applied to corporate taxpayers. This chapter, with the help of the diagram, reviews the current law, presents illustrations of more common capital gain and loss situations, and mentions the major exceptions to the provisions shown in the diagram.

The purpose of the diagram is to break the computation of gain or loss from capital transactions into a series of decisions presented in a logical fashion so that each individual case is relatively simple. Thus the reader or user of the diagram should be able to follow each asset disposed of through the diagram, arriving at the net taxable capital gain or loss. In making the individual decisions it will be necessary to rely on the definitions and explanations provided above.

Ordinary Assets. Regardless of the type of disposition that occurs, the resulting gains and losses are included in ordinary income.

Section 1231 Assets. Several decisions must be made in order to determine how the resulting gains and losses are included in income. The following is an outline of the necessary steps.

1. Determine the gain or loss from the disposition of each Section 1231 Asset.

2. Eliminate any loss from casualty or theft of uninsured property and include the loss in income as an ordinary loss.

3. Eliminate any gains which are subject to recapture and include any recaptured gain in ordinary income.

4. Accumulate the remaining gains and losses to determine the net gain or loss from dispositions of Section 1231 Assets.

5. If step (4) results in a net loss, all gains and losses are treated as ordinary gains and losses. Thus the amount of the net loss is deductible as an ordinary loss.

6. If step (4) results in a net gain, all gains and losses are treated as gains and losses resulting from the disposition of capital assets. Thus the net gain is considered as a long-term capital gain and is included in the computation of net long-term capital gain or loss.

Capital Assets. A number of possible combinations of situations may arise with respect to transactions involving capital assets. As a result the number of decisions is somewhat large. However, length is not always synonymous with complexity. The individual decisions to be made are still relatively simple. The steps involved are as follows:

Net Short-term Gain or Loss

1. Determine the length of the holding period for each asset disposed of and separate the assets into two categories--long-term and short-term.

2. With a view toward determining the net short-term gain or loss, determine for each disposition in the short-term category whether it resulted in a gain or a loss.

3. If step number (2) resulted in a loss, eliminate those losses which resulted from disposition of non-business capital assets. (These losses may be deductible as an itemized deduction if they resulted from casualty or theft subject to certain limitations.)

4. Combine the short-term gains with the remaining short-term losses and compute the net gain or loss from short-term transactions.

Net Long-term Gain or Loss

5. Eliminate long-term transactions which resulted in an involuntary conversion (Gains and losses on these dispositions are subject to treatment under Section 1231).

6. Determine whether each remaining disposition resulted in a gain or a loss.

7. In the case of a loss, if the loss was from the disposition of a non-business capital asset eliminate the loss as non-deductible (except where loss resulted

from casualty or theft in which case it may be deductible as an itemized deduction subject to certain limitations).

8. Combine the long-term capital gains with any net capital gain from Section 1231 Assets and the remaining long-term capital losses in order to compute the net long-term capital gain or loss.

Net Capital Gain or Loss

9. Combine any net short-term capital gain or loss (step 4) with any net long-term capital gain or loss (step 8) in order to determine the net capital gain or loss.

Taxable Income From Capital Asset Transactions

Net capital gain may be the result of three different combinations of net short-term gain or loss and net long-term gain or loss. The way in which the net capital gain is included in taxable income is different for each of these combinations.

10. Determine the particular combination of net short- and long-term gain or loss which caused the net capital gain.

11. If the net capital gain resulted from an excess of net short-term gain over net long-term loss or solely from a net short-term gain, the entire net capital gain is included in taxable income with no special treatment.

12. If the net capital gain resulted from a combination of net long-term gain and net short-term gain or solely from a net long-term gain, the net capital gain minus the long-term capital gain deduction is included in taxable income. The deduction in this case is equal to 50 per cent of the net long-term gain. (The alternative tax computation may be applicable in this situation.)

13. If the net capital gain resulted from an excess of net long-term gain over net short-term loss, the net capital gain minus the long-term capital gain deduction is included in taxable income. In this case the deduction is equal to 50 per cent of the net capital gain. (The alternative tax computation may be applicable in this situation.)

Deductible Loss From Capital Asset Transactions

From the standpoint of the portion of the net capital loss which is deductible in the year of the loss, no distinction need be made between net long-term and net short-term losses. However, from the standpoint of a capital loss carryover the distinction is important.

14. Determine whether the net capital loss is greater or less than net taxable income from sources other than capital transactions.

15. If the net capital loss is greater than other

income and other income is greater than \$1,000, the deductible loss is limited to \$1,000. (The amount of the net capital loss in excess of \$1,000 is subject to the capital loss carryover provisions.)

16. If the net capital loss is greater than other income and other income is less than \$1,000, the deductible loss is limited to the amount of other income. (The amount of the net capital loss in excess of other income is subject to the capital loss carryover provisions.)

17. If the net capital loss is less than income from sources other than capital transactions, and the loss does not exceed \$1,000, the entire net capital loss is deductible in computing taxable income.

18. If the net capital loss is less than other income but the loss exceeds \$1,000, the deductible loss is limited to \$1,000. (The amount of net capital loss in excess of \$1,000 is subject to the capital loss carryover provisions.)

Illustrations. The following examples are not intended to illustrate every possible situation; however, there is one example for every type of computation which may arise. This should be sufficient as a guide.

Computation of Net Short-term Capital Gain or Loss

Taxpayer sold stock for \$4,000 on July 5, 1965.
The stock had been purchased on March 5, 1965 for

\$3,200. In addition, the taxpayer sold bonds for \$2,000 on March 1, 1965. The bonds had been purchased on February 7, 1965 for \$2,100. The taxpayer had no other dispositions of short-term capital assets during 1965. Both of the assets disposed of were capital assets with a holding period of less than six months. The result is a net short-term capital gain of \$700 (\$800 gain on stock less \$100 loss on bonds).

Computation of Net Long-term Capital Gain or Loss

On February 16, 1965, taxpayer sold shares of stock in X Corporation for \$7,000; the shares had been purchased in 1960 for \$8,500. Also, the taxpayer sold shares of stock in Y Corporation on July 20, 1965 for \$5,000. The Y Corporation stock had been purchased in 1962 for \$4,200. The taxpayer had no other long-term capital gains or losses in 1965. Both of the assets sold were capital assets with a holding period in excess of six months. The result is a net long-term capital loss of \$700 (\$1,500 loss on X Corporation stock less \$800 gain on the Y Corporation shares).

Section 1231 Gain or Loss

Taxpayer's recognized gains and losses from Section 1231 Assets for 1965 are as follows:

Taxpayer sold machine used in business for \$15,000 on January 3, 1965. Adjusted basis was \$10,000 and depreciation taken after 1961 was \$2,000. The machine was acquired in 1962.

On July 2, 1965 taxpayer suffered fire damage to his personal residence causing a \$700 deductible loss. The home had been the taxpayer's residence for 10 years.

Taxpayer sold a two year-old car used in business for \$1,700 on January 16, 1965. The adjusted basis of the car was \$2,000.

The \$5,000 gain on the machine is composed of \$2,000 ordinary income (recaptured under Section 1245) and \$3,000 Section 1231 gain. The transactions result in a net Section 1231 gain of \$2,000 (\$3,000 gain on machine less losses of \$700 and \$300 for fire damage and car). Since the net result is a gain all three transactions are treated as gains and losses from the disposition of capital assets (had the net result been

a loss, the gains and losses would be ordinary).

Net Gain or Loss From Capital Asset Transactions

Taxpayer had a net short-term capital loss of \$3,400 and a net long-term capital gain of \$400 in 1965. This results in a net loss from disposition of capital assets of \$3,000.

Net Capital Loss (limited to \$1,000)

Taxpayer sold X Corporation stock on July 1, 1965 for \$10,000. The stock had an adjusted basis of \$8,500 and the acquisition date was in 1961. The only other disposition of a capital asset was the sale of Y Corporation stock on December 1, 1965 for \$3,000. The Y Corporation stock was purchased on October 15, 1965 and had an adjusted basis of \$5,500. The result is a net long-term capital loss of \$1,500 and a net short-term capital loss of \$2,500, or a net capital loss of \$3,500. Taxable income (without capital asset transactions) amounted to \$10,000.

The net capital loss is less than other income but greater than \$1,000 so that the deductible loss is limited to \$1,000 in 1965. (Carryover requirements indicate that the deductible loss reduces first the net short-term capital loss so that the taxpayer has a carryover loss consisting of \$1,500 short-term loss and \$1,500 long-term loss.)

Excess of Net Long-term Capital Gain over Net Short-term Capital Loss

In 1965 taxpayer had the following income and deductions: salary \$12,000; deductions from adjusted gross income, \$3,500; net long-term capital gain, \$6,000; and net short-term capital loss, \$3,000. Since the net long-term capital gain exceeds the net short-term capital loss, the capital gains deduction is limited to 50% of the net capital gain of \$3,000, or \$1,500. Taxable income is computed as follows:

Net capital gain	\$3,000	
Less long-term capital gains deduction	<u>1,500</u>	\$ 1,500
Salary		<u>12,000</u>
Adjusted gross income		\$13,500
Less deductions		<u>3,500</u>
Taxable income		<u>\$10,000</u>

(The alternative tax computation is unnecessary since taxable income is less than \$26,000.)

Corporate Taxpayers

The important differences in the treatment of corporate taxpayers as opposed to individuals have been mentioned above in the discussions of the alternative tax computation and the capital loss carryover provisions. All of the rules applicable to individuals are applicable to corporations except that corporations are not allowed a long-term capital gain deduction²⁸ and a net capital loss cannot be applied as an offset to ordinary income.²⁹

Since no long-term gain deduction is allowed, in the event of a net long-term gain which exceeds net short-term loss, if any, or a net long-term gain and a net short-term gain, the regular tax computation is made with the entire net capital gain included in taxable income. The alternative tax is derived by adding 25 per cent of net

²⁸Int. Rev. Code of 1954, Sec. 1202.

²⁹Int. Rev. Code of 1954, Sec. 1211(a).

long-term gain over net short-term loss to a partial tax computed on taxable income, excluding gain from capital asset transactions. In the case where there is net long-term gain and net short-term gain the partial tax is simply added to 25 per cent of the net long-term gain. Since the normal tax rate (22 per cent) is less than the long-term capital gains rate (25 per cent), the alternative computation will produce the lower tax in situations where taxable income exceeds \$25,000. Where taxable income is less than \$25,000, the regular tax computation will produce the lower tax. Thus, the effective tax rate can be as low as 22 per cent but not greater than 25 per cent.

In the event a corporation incurs a net capital loss, the loss, irregardless of whether it is long- or short-term, it can be deducted only as a short-term capital loss against the capital gains and losses of the five succeeding tax years (or until it is completely exhausted).³⁰

Major Exceptions

Sales Between Related Taxpayers. Gains from the sale or exchange of depreciable property, which may otherwise qualify for preferential treatment under the rules pertaining to Section 1231 or Capital Assets, which arise

³⁰Int. Rev. Code of 1954, Sec. 1212(1).

from transactions between related taxpayers are denied capital gain treatment. The Code defines related taxpayers as "husband and wife or an individual and a corporation more than 80 per cent in value of the outstanding stock of which is owned by such individual, his spouse, and his minor children and his minor grandchildren."³¹

Collapsible Corporations. In the event a taxpayer realizes a gain on the sale or exchange of collapsible corporation stock, or receives a distribution in payment for this type stock in a partial or complete liquidation, the gain is taxed as ordinary gain. Were it not for Section 341 this type of gain would qualify for preferred treatment under the capital gain and loss provisions. Collapsible corporations are defined generally by the Code as:

Collapsible corporation. - For purposes of this section, the term 'collapsible corporation' means a corporation formed or availed of principally for the manufacture, construction, or production of property, for the purchase of property which (in the hands of the corporation) is property described in paragraph (3), or for the holding of stock in a corporation so formed or availed of, with a view to-

(A) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders,

³¹Int. Rev. Code of 1954, Sec. 1239.

before the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the taxable income to be derived from such property, and

(B) the realization by such shareholders of gain attributable to such property.³²

The provisions of the law on collapsible corporations are quite involved and are beyond the scope of this paper. However, the basic rules may be obtained from this general description by Mertens:³³

(1) A corporation must be availed of principally to engage in certain activity, as a result of which it comes to own property.

(2) The activity consists of the manufacture, construction or production of any kind of property, or the purchase of certain kinds of property.

(3) This property grows in value in the hands of the corporation.

(4) The foregoing corporate activity is undertaken or executed with a view to getting the property into the hands of the stockholders, or enabling them to dispose of their stock, before the corporation realizes a substantial part of the income to be derived from the property.

(5) The stockholders realize gain attributable to that property.

(6) At any time during the foregoing activity the stockholder, whose tax status is involved, owned more than 5% in value of the outstanding stock in the corporation.

(7) More than 70% of the stockholder's gain in the taxable year, from stock in the corporation, is attributable to the foregoing property.

(8) Such gain is realized within a three-year period following completion of the foregoing corporate activity.

³²Int. Rev. Code of 1954, Sec. 341(b)(1).

³³Mertens, Jacob, Jr. The Law of Federal Income Taxation (Chicago: Callaghan & Company, 1958), vol. 3B, p. 236.

Losses on Small Business Investment Company Stock.

Exceptional treatment is afforded to losses on dispositions of stock if:

(a) In general. - Any taxpayer who sustains a loss for a taxable year beginning after September 2, 1958, as a result of the worthlessness, or from the sale or exchange, of the stock of a small business investment company (whether or not such stock was originally issued to such taxpayer) shall treat such loss as a loss from the sale or exchange of property which is not a capital asset, if at the time of such loss-

(1) The company which issued the stock is licensed to operate as a small business investment company pursuant to regulations promulgated by the Small Business Administration, and

(2) Such loss would, but for the provisions of section 1242, be a loss from the sale or exchange of a capital asset.³⁴

Losses on Small Business Stock. In the event a taxpayer disposes of certain shares of stock in a qualified "small business corporation" at a loss, subject to certain limitations, the loss is allowed as an ordinary rather than a capital loss. This rule applies only to individuals who qualify as the original purchasers of the stock. The stock must meet the requirements of Section 1244(c)(1) and the issuing corporation must meet the definition of a "small business corporation" as defined in Section 1244(c)(2). Although the details of this provision will not be discussed it should be pointed out that resulting ordinary loss

³⁴Fed. Inc. Tax Reg., Sec. 1.1242.1(a).

deduction is limited to \$25,000 in one tax year on a separate return and \$50,000 on a joint return.³⁵

³⁵Int. Rev. Code of 1954, Sec. 1244(b).

CHAPTER IV
THE TREATMENT OF CAPITAL GAINS AND LOSSES
IN OTHER COUNTRIES

Efforts to develop a sound and constructive income tax law should include a consideration of the experiences of other countries with their various income tax laws. Broad conclusions, however, based upon these experiences are very difficult. As pointed out initially, the whole subject of capital gains taxation is a highly complex one. What is a satisfactory solution in one country may not be appropriate elsewhere. As long as the consideration of tax laws in other countries is kept in the proper frame of reference and any conclusions garnered are regarded as tentative, such a study should provide valuable insight.

Capital gains taxation varies greatly among the major countries. Canada and Australia represent one extreme--the general rule is to exclude them from taxable income unless they have been incurred in the course of "trade." France and the United States represent the other extreme--the general rule is to include them in taxable income but with preferential treatment. No major country treats all capital gains as elements of ordinary income without making special allowances. Further, every major country disregards unrealized appreciation or depreciation

in their tax accounting, although it is not unusual to find that unrealized capital gains or losses enter into the annual net worth, net yield, or net worth increment taxes.

As can be determined by reference to the United States, tax laws comprise a large and complex body of statutes, court decisions, and administrative regulations and practices. The treatment of capital gains and losses presented here will be limited to a broad outline for each country. The countries selected for this presentation represent a cross section of major tax systems.

France

In describing the tax system of France the World Tax Series quotes various sources as follows: ". . . the French tax system is rarely the same two years running. No country has changed its fiscal system more often than France, and in no country has reform led more often to new complications."¹ This has certainly been true in the income tax area and particularly so as to capital gains. Significant changes have been made in each of the years 1963-65. The most recent changes will be mentioned in the description of the present French law.

¹World Tax Series: Taxation in France, (Chicago: Commerce Clearing House, Inc., 1966), p. 75.

Individuals. Generally, individuals are not subject to tax on gains realized on the sale of nonbusiness capital assets. The law makes a sharp distinction between gains on capital assets realized by an individual (nonbusiness) and those realized by a business enterprise (either individual or corporate). However, an individual's gains on security or property transactions may become subject to tax if the individual qualifies as a "habitual trader." In this situation gains become ordinary income taxed at ordinary rates (rates range from 5 per cent to 65 per cent). In effect, the habitual trader's capital assets become business assets. Criteria for this determination include the number and frequency of transactions, the length of holding periods of the assets, the number of different securities involved, and the magnitude of the transactions. Gains realized in the normal course of managing a portfolio are not taxable.

Based on 1963 legislation three rather narrow groups of transactions in real property of individuals are now subject to tax. These include gains from unimproved land for housing construction, gains realized by certain builders from the sale of housing, and gains realized in speculative real property transactions (generally defined as any having a holding period of five years or less). In addition, individuals are taxed on capital gains resulting

from the sale of a controlling interest in a corporation (a special flat rate of 8 per cent is applied²); the sale of founders' shares; the repurchase by a corporation of its own shares; and, the redemption of shares issued as stock dividends.

As a corollary, individuals are generally allowed no deduction for losses incurred on the disposition of nonbusiness capital assets. However, in the special circumstances where gains become taxable, losses are available to offset gains as well as ordinary income. A loss carryforward provision is also available.

Business Enterprises. The taxable income of a business enterprise (regardless of the form of operation) includes gains on sale of capital assets.³ For the first time the Tax Law of July 12, 1965 makes a distinction between short- and long-term capital gains. Prior to September 1, 1965, all business gains were taxed as ordinary income at the ordinary rate of 50 per cent. Under the new law net short-term gains are still taxed at the full rates. A new provision allows a net short-term gain to be spread equally over a five-year period beginning

²General Tax Code, Article 160.

³General Tax Code, Article 38-1.

with the year of realization. Long-term gains, however, are taxed initially at a special rate of 10 per cent. The remaining gain (90 per cent of the total gain) is to be set aside in a special reserve. The reserve is available tax-free to be either incorporated in capital or to be used to offset future losses. In the event the reserve is used for some other purpose, such as distribution in the form of dividends, an additional 40 per cent tax is levied.

Short-term capital gains are defined as items with a holding period of less than two years plus gain to the extent of depreciation deductions taken on items with a holding period of two years or more (recapture depreciation). Short-term losses include losses incurred on the disposition of nondepreciable assets held less than two years plus losses incurred on depreciable assets regardless of the length of the holding period. Long-term gains and losses are defined to include gains and losses not specifically set out in the short-term category.

While net short-term capital losses may be deducted in full against ordinary income in the year incurred, a net long-term capital loss is allowed only as an offset against long-term capital gains during the succeeding ten-year period. In making the distinction between long- and short-term gains and in providing special benefit to both

categories (net short-term gain is spread over a five-year period and net long-term gains are subject to the special 10 per cent rate), rollover provisions for capital gains were done away with by the 1965 legislation. Previously capital gains were subject to deferral by reinvestment in qualified assets.

Noncommercial Activity. Capital gains realized by certain professions such as doctors and lawyers are classified as noncommercial income and given special treatment. Gains on assets devoted to the professional activity are provided a 50 per cent exclusion and taxed at the normal rates if the holding period of the asset is less than five years. For similar assets with a holding period of five years or more, the entire gain is taxable at a special flat rate of 6 per cent.⁴

Dispositions. Since there is no capital gains tax on nonbusiness capital assets, disposition in relation to those assets is not important from a tax standpoint. It is interesting to note, however, that where business assets are concerned transfers by gift or at death are regarded as equivalent to a sale or cessation. Upon the death of a proprietor of a business enterprise, capital gains tax

⁴General Tax Code, Articles 152 and 200.

becomes payable. If the business is left to and carried on by direct line successors, however, the tax thus due may be deferred. Deferral is also possible where a lifetime gift of a business enterprise is made to persons who would be the donor's direct successors. In the event that a taxable capital gain arises due to a gift, the gain is taxed at full rates, in the case of a death a flat rate of 6 per cent is applied.⁵

Great Britain

Great Britain provides an illustration of the dangers of making generalizations about the appropriateness of tax systems employed by others. For a number of years, opponents⁶ of the capital gains tax in the United States have put forth the argument that since the British do not tax capital gains, the United States should not. Until 1962 this was at least partially true (only "trading" gains were subject to tax). The Finance Act of 1962 initiated a tax on short-term capital gains and the Finance Act of 1965 broadened the scope of the tax to include long-term capital gains. The taxation of capital gains

⁵General Tax Code, Article 152-1.

⁶See comments by Walter J. Blum in "A Handy Summary of the Capital Gains Arguments" Taxes, vol. 35 (April, 1957), p. 248.

and losses in Great Britain now bears a strong resemblance to the United States' scheme. Apparently some highly persuasive individuals or groups in Great Britain successfully argued that since the United States has always taxed capital gains, Great Britain should follow suit.

Short-Term Gains Tax. The provisions applicable to the taxation of short-term gains are basically those of the Finance Act of 1962.⁷ The Finance Act of 1965⁸ modified the 1962 provisions somewhat. The present law is complicated by the transitional rules that were necessitated by the 1962 Finance Act. For current tax problems these rules are very important but they would only confuse an effort to describe the general treatment provided by the new law, thus they are omitted.

A short-term gain or loss results from dispositions of chargeable assets which take place on or after April 7, 1965 if the disposition precedes the acquisition or if the disposal occurs within a one-year period after acquisition. Short-term gains are to be taxed in full as

⁷Finance Act of 1962, Secs. 10-16, Halsbury's Statutes of England (London: Butterworth & Co. Ltd., 1963), vol. 42, pp. 340-57.

⁸Finance Act of 1965, Secs. 17 and 18, Halsbury's Statutes of England (London: Butterworth & Co. Ltd., 1966), vol. 45, pp. 525-9.

ordinary income while short-term losses are allowable only against short-term gains of the same or of a subsequent year.

Long-Term Gains Tax. The 1965 Finance Act⁹ imposes a tax on long-term capital gains resulting from dispositions of chargeable assets with a holding period in excess of one year and occurring after April 7, 1965. The tax on individuals is at a flat rate of 30 per cent; however, an alternative to the flat rate is available. The individual has the option of including one-half of his net chargeable gains or his net chargeable gains less 2,500 pounds, whichever is the larger, in ordinary unearned income. Whichever approach yields the lower tax is available to the individual.

In the event a disposal results in a long-term loss, relief is allowed for the loss against long-term gains of the same year or, if they are insufficient, against long-term gains of subsequent years. In no case can long-term losses offset short-term gains nor can short-term losses offset long-term gains.

Chargeable Persons.¹⁰ Any person resident or

⁹ Finance Act of 1965, Sec. 19, Ibid., pp. 530-1.

¹⁰ Finance Act of 1965, Sec. 20, Ibid., pp. 531-3.

ordinarily resident in the United Kingdom is chargeable on gains accruing to him in a year of assessment during any part of which he was a resident. A non-resident is subject to the tax only in the case where disposition of an asset situated in the United Kingdom occurs and that asset was used for "trade" purposes. Companies whose central control and management are located in the United Kingdom and are thus resident are liable to tax on all their capital gains, regardless of where the assets are situated.

Chargeable Assets.¹¹ Subject to special rules and exceptions, all forms of property regardless of situs are chargeable assets. The definition includes debts, options, currency, incorporeal property, and any form of property created by a person disposing of it. Sections 27-40 provide exemptions for such things as passenger cars, gifts (not exceeding 100 pounds in one year), certain Government securities, gambling winnings, compensation for personal or professional injuries, private residences, chattels sold for 1,000 pounds or less, assets used in a trade, and gains on disposal of a business at retirement.

¹¹ Finance Act of 1965, Sec. 22, Ibid., pp. 535-7.

Disposition.¹² Disposal of an asset is defined to include any method of transfer of ownership including a sale, lease or gift. Further, it covers the transfer of ownership by reason of death. Since transfers at death or by gift result in the taxation of capital gains, the British law goes further than the United States law. Under British law it is possible to postpone capital gains tax but there is no way to escape it.

Companies. The Finance Act of 1965¹³ also initiated a new corporation tax. The corporation tax provisions apply to capital gains and losses as well as to profits so that capital gains are assessed at the corporate tax rates. The provisions described above with respect to what constitutes a chargeable gain applies to companies with some modification. The result is that companies will be taxed on all of their capital gains regardless of the length of the holding period.

Canada

Prior to Great Britain's radical change which began in 1962, Canadian and British practice with respect to the taxation of capital gains were very similar. Canada's

¹² Finance Act of 1965, Secs. 22 and 24, Ibid., pp. 535-7.

¹³ Finance Act of 1965, Secs. 46-89, Ibid., pp. 572-644.

practice now represents a significant departure from the British practice. In Canada (unless assets are of the nature of stock-in-trade in the hands of the seller), land, buildings, patents, securities, and other assets, whether used in trade or business or held for investment, may be disposed of by either individuals or corporations without the recognition of any gain or loss for income tax purposes.¹⁴

Canadian income tax law is unique in that its statutes are substantially borrowed from the United States while its jurisprudence derives from Great Britain. Although the present statutes fail to define income with any particularity, the legal definition¹⁵ in force from 1917 until the 1948 statutory revision was closely akin to the United States' definition and could have been used as a basis for taxing capital gains. From the beginning the courts interpreted income to include only income from a trade or business and to exclude accretions to capital.

To say that capital gains are exempt from tax does not eliminate the problem of determining exactly what

¹⁴Income Tax Act of 1948, chapt. 148, Revised Statutes of Canada-1952 (Ottawa: Queen's Printer and Controller of Stationery, 1952), vol. III, pp. 3205-3348.

¹⁵Income Tax War Act of 1917, Sec. 3, Revised Statutes of Canada-1927 (Ottawa: Frederick Albert Acland, 1927), vol. II, p. 2139.

constitutes a capital gain. In Canada this hinges largely upon questions of fact concerning whether or not a particular sale was made in the course of a trade or a business. Past decisions indicate that important factors in determining what constitutes carrying on a trade include: the nature of the transaction, its size and complexity, the frequency of such transactions, and the intentions of the taxpayer. Despite years of experience and numerous court decisions, the distinction between income and capital gain in Canada is not a clear one. One can say with certainty that capital gains are tax exempt in Canada but one can never be positive as to what constitutes a capital gain.

A significant exception to the general rule that capital gains and losses can be disregarded in the computation of taxable income involves dispositions of depreciable assets.¹⁶ When depreciable assets are sold and the proceeds exceed the book value, gain to the extent of the prior depreciation is to be credited to the balance of the undepreciated capital cost for that type asset. The effect is to reduce future depreciation charges. If the proceeds credited reduces the capital balance of that type asset below zero, the excess credit becomes taxable although it

¹⁶Income Tax Act of 1948, op. cit., pp. 3224-9.

may be spread over the five preceding tax years. To the extent the proceeds on a disposition exceed the original cost, a capital gain results and is not subject to tax.

Germany¹⁷

Tax law in Germany generally excludes from taxable income gains and losses from the sale of private property. However when gains and losses are incurred on sales of assets related to trade or business they are included in taxable income without any special treatment. A significant change in the German law, effective January 1, 1965, provides for deferral of gain for both individuals and corporations where qualified reinvestment is made.

Individuals. German law places a great deal of emphasis on the distinction between business and nonbusiness activities. Gains and losses from the disposition of nonbusiness property are reflected in taxable income only if the property was held for less than the statutory period and only then if the net gain is DM 1,000 or more. The statutory holding periods are two years for real property and six months for other property (including securities). When taxable income arises on nonbusiness property it is

¹⁷Provisions relating to capital gains and losses are set out in Section 23 of the Income Tax Law.

taxed at full rates (range of rates is presently 19 to 53 per cent). Net losses are not available as offsets against other income nor do they qualify for carryover or carry-back.

Prior to January 1, 1965, gains and losses from dispositions of business property incurred by an individual were fully includable in ordinary income. Since January 1, 1965, losses continue to be fully deductible against other income but certain gains may be deferred either by reinvestment in qualified assets or not including them in taxable income until the third year following the year of disposition. Conditions to be met in order to qualify for this special treatment include: the assets replaced must have a holding period of not less than six years, the business must be a permanent West German establishment, the assets replaced as well as their replacements must be capital assets, and the financial accounting treatment of the gain must follow the tax treatment. Not all assets meeting these requirements are eligible for this special treatment and gain from one type of capital asset may not be reinvested in all other types of capital assets. However, the provisions in this respect are very liberal. Reinvestment must take place within the two taxable years following disposal. If no reinvestment is made, the gain must be included in taxable income in the third following

fiscal year. In case of reinvestment, the basis of the replacement asset is reduced by the amount of the nonrecognized gain. Effectively, the taxation of all gains is postponed from three years to an indefinite period.

A special set of rates (approximately one-half of the normal rates) applies to individuals who under certain circumstances dispose of a "substantial interest" in a corporate entity or sell or discontinue an unincorporated business.

Corporate Taxpayers. Prior to January 1, 1965, all capital gains and losses incurred by corporate taxpayers were included in ordinary income and the full ordinary rates¹⁸ were applicable. As in the case of the individual (where business assets are concerned), since January 1, 1965, losses remain fully deductible, however, gains may be deferred by reinvestment in certain other capital assets. The reinvestment procedure applicable to individuals which are described above also apply to corporate taxpayers.

¹⁸The present tax rates are 15 per cent for distributed income and 51 per cent for retained income. Since only net profits after tax are available for distributions, the effective rate of tax on distributed income from current year earnings is approximately 23 per cent.

CHAPTER V

THE NATURE OF CAPITAL GAINS AND LOSSES

The purpose of this chapter is to review the nature of capital gains and losses and to discuss how they should fit (if at all) into the scheme of taxation. Various proposals to reform the taxation of capital gains and losses rest on their nature, both from a theoretical and a practical view.

This presentation will be centered around three questions: Are capital gains income? Should capital gains be treated as taxable income? Is special treatment justified?

Concepts of Income

There are a number of different concepts of income that are relied on to support various positions on how capital gains and losses should enter the tax picture. The concepts have been derived for completely different purposes (none specifically for income taxation) with the result that there is much debate over the word "income." Whether or not one characterizes an item as income may depend on a number of factors such as the understanding of the item on the part of the individual, the use to which an individual may put an item, the manner in which the

item was acquired and disposed of, and the degree of ownership of the item. Professor Seltzer points out that disputes over income are pointless and lead nowhere. He indicates that the important question is not what is income but what concept of income is most suitable for income taxation.¹ Mr. Seligman agrees when he states:

To talk about whether capital gains are, or are not, income just gets into endless theoretical discussion. The real question is whether or not capital gains should be taxed in the same way that current income is. Maybe they are entirely different animals, but nevertheless they might for various reasons justify taxation in the same manner that current income does.²

The writer agrees with this position. However, the concepts of income lend insight to the more important question and are presented here as necessary background.

Common Usage

People in general commonly regard ordinary income or loss as arising from sales of goods and services which are a part of the seller's stock-in-trade or which he regularly offers for sale. Realized gains and losses on other assets are regarded as capital gains and losses. Profit earned through the regular operation of plant and

¹Capital Gains Taxation, (New York: Tax Institute Incorporated, 1946), p. 7.

²Ibid., p. 14.

equipment would be thought of as ordinary income, whereas, profit earned by an operating company through the sale of investment securities would be thought of as capital gain.

As Professor Blum points out, the fact that most people do not regard capital gains as income, at least from the standpoint of its availability for consumption, is an important consideration. He feels, however, that this is not an expression of public opinion, but the lack of it since most people are not conversant with the problem or its background and thus are not acquainted with the concept.³ Whether or not people treat capital gains as income has no bearing on the problem. If people were informed on the various concepts of income they may very well react differently to capital gains.

Legal Usage

The legal concept of income divides an asset into corpus and income interests. It holds, except where otherwise provided by the creator of the interests, that income is something that arises from a fixed source, regularly recurs, and that it inures for the benefit of the income interest. Capital gains, on the other hand, are of

³Walter J. Blum, "A Handy Summary of Capital Gains Arguments," Taxes, vol. 35 (April, 1957), p. 249.

a nonrecurring nature and arise from a change in the value of the property itself. They inure to the benefit of the corpus interest.

This concept has a long lineage which can be traced back to the period when England's economy was predominately agricultural. During this period the practice of entailing estates arose and necessitated the distinguishing between what portion of an estate was due the income and the corpus interests. Income came to be regarded as the yield of the land which could be separated from the land without causing its depletion. Any appreciation in the value of the land was not thought of as income since the life tenant had no power to realize the appreciation. He had rights only to a thing, land, not its monetary value.

As pointed out in a detailed handling of the development of this concept,⁴ economic conditions changed quickly in the United States so that realized capital gains took a more conspicuous place than they had in England. Even though intangible forms of wealth, particularly securities, are dominant in our present society, the concept that capital is the thing and that income is the flow from it continues to influence our property laws.

⁴Lawrence H. Seltzer, The Nature and Tax Treatment of Capital Gains and Losses (New York: National Bureau of Economic Research, Inc., 1951), pp. 25-30.

The legal concept gives no help in trying to arrive at how capital gains should be treated from an income tax standpoint. Its purpose is to determine which of two interests in property should properly be credited with appreciation in value of the property. This is unrelated to the concept of what should constitute ordinary income under the tax law.

Economics. In the field of economics there is no generally accepted concept of income. One view is that an expected rise in the price of any asset is ordinary income while an unexpected rise is a capital gain.⁵ Irving Fisher attempted to define income as merely consumption.⁶ Much broader definitions include "net accretion to economic power"⁷ and the "algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period."⁸

⁵J. R. Hicks, Value and Capital (London: Oxford University Press, 1939), Chapter XIV and John M. Keynes, General Theory of Employment, Interest and Money (London: Macmillan Company, 1930), pp. 52-61.

⁶Irving Fisher, The Nature of Capital and Income (New York: The Macmillan Company, 1906), p. 106.

⁷R. M. Haig, "The Concept of Income," The Federal Income Tax (New York: Columbia University Press, 1921), Chapter 1.

⁸Henry C. Simons, Personal Income Taxation (Chicago:

Sales of capital assets are generally unexpected since one usually does not expect to sell one's capital assets in the ordinary course of business. This definition generally excludes capital gains from ordinary income. However, the definition of capital assets is broad enough to include assets which are definitely bought with full intention of future disposition at a gain. It is a difficult concept to work with since it involves a necessarily subjective judgment in separating the expected from the unexpected. The consumption definition omits capital gains from income. This is true since the prudent investor does not view a capital gain as being available for consumption. Capital gains are viewed as nonrecurring with the possibility that a capital loss will follow. Thus to maintain capital resources and to provide for possible future losses, capital gains are not available for consumption purposes and consequently, not income.

The broader definitions of income are all inclusive so that capital gains are included as well as the value of gifts and inheritances. Such a definition appears to most⁹ a sound theoretical approach. However, it requires

The University of Chicago Press, 1938), p. 50.

⁹A notable exception is Simons (Ibid., pp. 125-147) who would treat gifts as taxable income to the recipient.

modification to be useful. Adjustments would seem appropriate with respect to gifts and inheritances and to the unrealized appreciation and depreciation which would be included. Congress has consistently applied a modified version of this definition. The usefulness of this concept has been to point out that "capital gains constitute real taxpaying ability to the recipient no less than equivalent income derived from other sources."¹⁰

Accounting. Conventions of accounting generally call for ignoring the unrealized gains and losses resulting from changes in the values of capital resources employed by a business enterprise. Realized gains and losses from these resources are accounted for as extraordinary items of income or loss and in reporting net income are segregated from other items constituting ordinary or operating income. In this sense accountants do not treat capital gains as ordinary income.

Unrealized changes are not taken into account due to reluctance to repeatedly revalue assets and since conservatism demands recognition of profits be postponed until realization. The segregation of capital-type gains

¹⁰ Report of the Subcommittee on Proposed Revision of Revenue Laws of the Committee on Ways and Means, 75th Cong. 3rd Sess. (Washington: United States Government Printing Office, 1938), p. 30.

from the ordinary or operating type items on the income statement is necessary to ensure that the regular annual results of operating a business will not be distorted by large nonrecurring, nonoperating types of gains and losses. The treatment of modern financial accounting is predicated on practical considerations and the desire to produce more useful financial statements and in no way indicates what the income tax treatment of capital gains and losses should be.

Sources of Capital Gains and Losses

The discussion of the nature and sources of capital gains and losses is helpful in attempting to draw conclusions about whether or not they constitute income. In addition it will shed some light on the discussion to follow on whether or not capital gains and losses should be included in the concept of taxable income.

Capital gains and losses are the realized increases and decreases in the value of personal or corporate wealth which are included in the class of assets referred to as "capital assets." These changes in value may arise from a diversity of factors. In considering whether capital gains and losses are income or how they should be treated for income tax purposes each of these factors and their relative importance must be considered. This is complicated

by the fact that a particular capital gain or loss can conceivably be caused by one factor acting alone or by any combination of two or more of the factors. Another difficult problem from either the income or the tax policy approach that will be brought out is that some gains and losses are real and others are illusions; some are permanent and others temporary. Furthermore, some accrue gradually over more than one tax year and others accrue quickly over periods as short as a few hours. Some gains and losses tend to be recurrent, almost like salaries and wages; while others occur with little likelihood of recurrence.

Retained Earnings. An element which contributes to the creation of a capital gain in the case of corporate securities is the earnings of a corporation which are reinvested rather than paid out in the form of dividends. When corporations reinvest substantial amounts of earnings in profitable ways the book value of the common stock increases and the market value will tend to follow. Other things being equal, the market value will increase as a reflection of the increase in underlying asset value and earning power. Security prices reflect the prospects for future earnings, rather than invested capital; however, retained earnings help to create future earnings. No

successful attempts have been made to correlate the movement in market price of corporate shares with the change in the amount of retained earnings. As a result there is a difference of opinion as to how important retained earnings are as a factor causing capital gains. Most would agree that over a long period of time successfully employed retained earnings will be reflected in some proportion in the market value of securities. Professor Seltzer, based upon a rather limited study, stated that factors other than retained earnings are of greater causal importance.¹¹ Most authorities indicate corporate saving is a very important source of capital gain but admit that correlation between book values and market values is generally poor.¹² The relationship between retained earnings and the market price of securities may be indirect and slow in coming about but all agree that it is there. Whether it is a major or minor factor in the creation of capital gain is debatable.

¹¹Capital Gains Taxation, op. cit., p. 12. In support of his conclusion he cites several examples of large corporations where over a four-year period there was actually an inverse correlation between reinvestment and the market price of stock.

¹²Federal Income Tax Treatment of Capital Gains and Losses (Washington: United States Treasury Department, 1951) p. 12. Here the relationship is described as "significant" and Blum, op. cit., p. 264. Professor Blum indicates that retained earnings have been a "major factor."

Price Level Changes. A major cause of capital gains particularly in recent years has been the significant change in the purchasing power of the dollar. Gains and losses which are the result of changes in the general price level are not real, but illusory. An asset which keeps pace with a price level increase will command more dollars but the purchasing power of the dollars will remain unchanged (this is the illusion). To the extent that a capital gain results from this factor, there is no gain in any real sense. Viewed in a different way, however, a change in the general price level may result also in real gains or losses. When the general price level increases, particular assets may advance faster, at the same rate, or slower than the general price level. To the extent that an asset advances faster than the general level, a real gain occurs. One which just keeps pace has an illusory gain, while one which advances slower suffers a real loss.

Another aspect of capital gain which is a result of price fluctuations is the specific price change. By a specific price change is meant a change in the price of one asset relative to another as opposed to a change in the general price level. Changes in specific prices result in real changes in command over goods and services and

they need not be accompanied by a general price level change. Relative changes in prices of assets may be caused by numerous factors such as shifts in preferences of investors or consumers, changes resulting from innovations, discoveries, or such things as increases in efficiency of operation. General price level changes, on the other hand, are associated with monetary expansion or contraction.

Price level changes result in both real and illusory gains and in practice the two are seldom distinguished. A difficult aspect of capital gain and loss is, then, that the same dollar amount of gain or loss may represent to one taxpayer a real change in economic position and to another a pure illusion with no change in ability to command goods and services.

Change in Interest Rates. Another source of capital gains and losses arises from changes in interest rates. Fixed income securities, such as bonds and preferred stocks, are priced in the market based on their fixed yields. Other factors, of course, affect the market prices but, other things equal, a fall in the interest rate will cause outstanding fixed income securities to rise in price in order to equate their effective yield with the yield of comparable securities issued at the new lower

interest rate. The reverse of this is true for increases in the interest rates.

For example, an investor purchases at par \$100,000 principal amount of 5 per cent bonds. The interest is payable annually and the bonds have 30 years to run. If the interest rate should fall to 4 per cent, the bonds could be disposed of for about \$117,000. Such a disposition under present law would result in a realized capital gain of \$17,000.

In practice it is impossible to determine the amount of change in market price that is attributable to changes in interest rates. First, the relevant rates of interest cannot be inferred from the market; there are literally thousands of interest rates. Further, if a close approximation of the "rate" of interest was available, it would be impossible to segregate the amount of change in a particular security price which was due to interest rate changes from that which may be due to numerous other factors which influence the market price of securities.

Whether or not the \$17,000 gain in the example is real or illusory is debatable from two viewpoints. From the standpoint of earning power the taxpayer is no better off since the entire sum would have to be reinvested in order to generate the same dollar amount of income. To tax this gain would reduce the earning power of the taxpayer. On the other hand, the \$17,000 represents

increased ability to command economic goods and services. If taxable income is to be based on earning power a tax on this type of gain would not be justified. If the total accretion to wealth concept is used the tax would be fully justified.

Change in Expectations. Since capital values reflect, to a large extent, the present worth of expected future receipts, a capital gain or loss may arise due to changes in expectations of what future receipts will be and how likely they are to be realized. Change in expectations may arise from several different sources with each of the sources in turn being influenced by a large number of factors. Expectations depend on the amount or duration of the future yield, the probability that a future yield will become a reality, and the relationship between the future yield and the present income possibilities.¹³ The yield, its probability, and the relationship of the yield to present income are based on precarious knowledge of what is presently taking place and what will take place in the future. Also the limited knowledge is subject to evaluation by each investor and this is dependent on the psychological mood of the investors which is itself in a

¹³Federal Income Tax Treatment of Capital Gains and Losses, Ibid., p. 15.

state of constant fluctuation.

The list of underlying factors which could result in a change in expectations would be endless. They are not limited to economic considerations but include influences from the social and cultural areas as well. The effect of a particular factor is subject only to vague calculation, if at all, and probably none can be estimated precisely. Occasionally, however, developments exert influences, the effect of which is obvious such as the assassination of President Kennedy in 1963, the development of a spectacularly successful product, or the significant suburban movement which has taken place in recent years. Factors may include changes due to tax policies, innovation or discoveries, competitive situations, efficiency of operations, changes in managements, or product acceptance. The psychological mood of investors which determines the willingness to accept risks and uncertainties is based on, in addition to economic judgments, each investor's family, social, religious, and cultural environment. All of these factors enter into the expectation of each investor on which decisions are made. The conglomeration of individual expectations comprises the expectation of the general investing public.

Should Capital Gains be Included in Taxable Income?

Most Authorities Indicate in the Affirmative. As noted by Professor Musgrave, "the concept of taxable income which has gained increasing acceptance among fiscal theorists is that of total accretion."¹⁴ This concept as described above defines income as consumption during a given period plus the change in total net worth. All accretions to total wealth regardless of form or source are seen as constituting income. On the other hand, all diminutions of wealth are taken into account in determining income regardless of their nature. Practical and administrative considerations do not permit strict adherence to this concept but it does provide a consistent theoretical basis for determining taxable income. The generally accepted modifications of the total accretion concept of taxable income are that only realized gains and losses be included¹⁵ and accretions due to gifts and bequests be excluded.

Other authorities firmly reject the total accretion concept of income; however, they generally agree that

¹⁴Richard A. Musgrave, The Theory of Public Finance (New York: McGraw-Hill Book Company, Inc., 1959), p. 165.

¹⁵However, as indicated in the discussion of reform proposals (Chapt. VI) some would include part, if not all, unrealized gains and losses in taxable income.

capital gains and losses should be included in the concept of taxable income. Their position is that even though capital gains and losses do not represent "true income," overriding considerations require that they be included in taxable income. For example the late George O. May strongly defended on a theoretical basis the English position of not taxing capital gains.¹⁶ Yet at the same time he conceded, "I think it is almost politically necessary to tax capital gains,"¹⁷ and, simply "I regret to conclude that it is necessary to tax capital gains."¹⁸ Don Throop Smith also rejects the total accretion concept but accepts that "capital gains be regarded as having a definite taxpaying capacity, somewhat analogous to but quite different from income, and hence reasonably subject to some taxation. . . ."¹⁹

What are the reasons that cause those who do not view capital gains as income to view them as proper for inclusion in taxable income and why have many fiscal theorists accepted the total accretion concept for taxable

¹⁶Capital Gains Taxation, op. cit., pp. 21-23 and 34-37.

¹⁷Ibid., p. 22. ¹⁸Ibid., p. 96.

¹⁹Dan T. Smith, Federal Tax Reform (New York: McGraw-Hill Book Company, Inc., 1961), p. 119.

income?

Political Expediency. One reason as mentioned by Mr. May is political expediency. The history of capital gains taxation indicates that at no time has Congress treated capital gains as anything other than an acceptable base for the income tax. This includes the Civil War income taxes as well as the modern income taxes. This long standing precedent is not likely to allow departure from the taxing of capital gains for many years to come.

Ability to Pay. A more important factor which underlies the precedent in the United States is that capital gains and losses have a direct bearing on the ability of a taxpayer to pay income taxes. A subcommittee of the House Ways and Means Committee stated "Capital gains constitute real taxpaying ability to the recipient no less than equivalent income derived from other sources."²⁰ Conceptual theorizing cannot obscure this fact (to which Congress has consistently adhered). It might appear that Congress wavered in granting preferential treatment. This was not the case since preferential treatment had as its purpose relief for high taxes which resulted from the

²⁰ Report of the Subcommittee on Proposed Revision of the Revenue Laws of the Ways and Means Committee, op. cit.

"bunching" of income and to eliminate the adverse economic effects which were the consequence.²¹ There is no evidence that this concession was based upon possible "illusory" or "unreal" elements in capital gains. The ability to pay proposition asserts that a taxpayer having a dollar of capital gain can command the same amount of economic power²² with it as with a dollar of economic enhancement which accrues in any other form. This is not to say that there are no illusory or unreal elements of capital gains but that the same elements appear to a greater or lesser degree in other forms of economic gains (even salaries and wages).

True Income Would Escape Taxation. The above analysis of the source of capital gains and losses indicates that they include elements of real income as well as elements that are unreal. It has been pointed out that the relative magnitude of the real and unreal elements is

²¹The House report on the Revenue Act of 1921 gave the following reason for preferential treatment: "The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under present law taxed as a lump sum. . . . in the year in which the profit is realized."

²²A taxpayer experiencing a capital gain can command resources and channel them at his choosing by either spending or saving. This ability exists even before the gain is realized.

subject to debate and in a specific instance impossible to determine accurately. Whatever the magnitude of the element of real income (and the total accretion concept indicates it is substantial), to exclude capital gains from the tax base would be inequitable since some elements of real income would go untaxed. For example, in the case of reinvested profits the tax system would obviously be incomplete for stockholders of a nondistributing corporation would be able to completely avoid taxation on their shares in the corporate profits.

Other Considerations. An extensive summary of arguments against the taxation of capital gains has been compiled in an article by Professor Blum.²³ Arguments for the preferential treatment of capital gains (which are the same as arguments for not taxing capital gains) are presented and then discounted in the article. The major objections to the taxation of capital gains have been mentioned above. Most of them are involved in the applicable concept of income and the unreal or illusory elements contained therein. The arguments dealing with the possible adverse economic effects of a capital gains tax certainly do require consideration and will be mentioned

²³Blum, op. cit., pp. 247-266.

in the following section which reviews the pros and cons of preferential treatment.

Should Capital Gains and Losses Receive Special Treatment?

"Bunching" of Income. The total accretion concept of taxable income which would take capital gains and losses into account as they accrue is theoretically superior to the "realization principle" which is resorted to only for practical reasons. Under the realization principle, gains and losses which accumulate over several years are arbitrarily assigned to the period of sale. This type of income is differentiated from other sources which accrue and are subject to tax in the same period. Congress recognized this in the consideration of the preferential treatment afforded in the Revenue Act of 1921.²⁴ It has been generally accepted that it is inequitable to tax at progressive rates, in a single tax year, capital gains which have accrued over a period of several years.

The so-called "bunching effect" of subjecting capital gains to taxation only at the point of realization demands some type of special treatment. The preferential treatment afforded long-term capital gains under the present law is partly justified because of this effect. However,

²⁴See footnote 21.

the amount of tax preference given long-term gains has generally been substantially greater than the amount of the tax rate adjustment required by this equity consideration.²⁵ From the standpoint of "bunching" alone, the special rates are lower than are required to eliminate the inequity of having gains taxed in one year. Bunching calls for some type of averaging arrangement rather than for partial exclusion with a relatively low maximum rate. A better solution would be to eliminate the problem by spreading capital gains and losses over several years. No approach can compare with the equity of averaging. Attempts to gain a result similar to averaging by such treatment as the present law calls for can only lead to effective rates which are too low for some taxpayers and too high for others. Since 1964 income from other sources has been subject to a limited form of averaging.²⁶ What is called for, then, would not be properly referred to as preferential from the standpoint of other income, but it would be special when compared to the provisions of the present capital gains provisions.

²⁵Federal Income Tax Treatment of Capital Gains and Losses, op. cit., p. 13.

²⁶See discussion of income averaging in discussion of reform proposals (Chapter VI).

Economic Effects. The effect of the capital gains tax on the level and type of economic activity is not clearly established. At one time or another the United States has prospered with high rates and suffered with low rates. Fluctuations in the prices of assets have been experienced with both high, low, and no capital gains tax. The English, who until recently had no tax on capital gains, have encountered pronounced booms and depressions in their economy. Perhaps the effect of such a tax on the economy is difficult or impossible to isolate due to the myriads of other relevant factors; however, to assume that a capital gains tax does not exert a definite influence on sales and exchanges, the prices of assets, and the level and type of investment undertaken is completely illogical. Furthermore, at some level the effective tax rates may reach it would certainly exert a dampening, if not stifling, influence on the factors of the economy mentioned above. Whether this would be viewed as a good or bad situation would depend on the goals of the economy at the particular time. At times and to some people there is nothing sacred about a high rate of economic activity, particularly since uneconomic activity is often a by-product.

The study done by Wilbur Steger on the economic consequences of taxing capital gains at the full progressive

rates strongly supports preferential treatment.²⁷ Some weight may have been taken from his conclusions due to the downward revision of individual tax rates in 1964; however, they would very likely be the same if the present rate structure were substituted. Furthermore there is some doubt that the present lower rates will long be in effect. Steger concludes that subjecting capital gains to full taxation would . . . "substantially increase the impediment imposed on the mobility of capital assets . . ."²⁸ Note that the statement implies that there is already some degree of impediment. The increased impediment would result from an increase in the effective rate of tax on capital gains and would be true with or without averaging. Based on Steger's study an averaging device would be of little benefit if the high progressive rates were maintained. On a five-year proration approximately three-fourths of the taxpayers claiming capital gains would reduce their taxes less than 5 per cent compared to the taxes paid without a proration device.²⁹

²⁷Wilbur A. Steger, "Economic Consequences of Substantial Changes in the Method of Taxing Capital Gains and Losses." Tax Revision Compendium (Washington: United States Government Printing Office, 1959), Vol. 2, pp. 1261-1283.

²⁸Ibid., p. 1280.

²⁹Ibid., p. 1264.

The immobilization of capital which occurs actually results from the employment of the realization principle. A tax on capital gains adds a tax cost to the sale of an asset while no comparable cost exists for holding the asset. If unrealized gains were taxed there would be no discrimination and this criticism would be eliminated. The degree of discrimination is greatly increased due to the possibility of completely escaping tax on unrealized gains at death. The taxation of unrealized capital gains at death would greatly reduce this discrimination; the advantage to holding would be limited to the difference in the present value of paying the tax at two different points in time.

Many investors are not affected in their decisions by the advantage of holding appreciated assets. Often institutional investors are tax exempt; unsophisticated private investors (presumably a large percentage fall into this category) ignore tax considerations. Other factors such as policies for investing for the "long-run," desires to maintain investment in certain enterprises at particular levels, and involuntary realizations exert overriding influences on decisions.

Thus it is possible to argue that the capital gains tax constitutes an impediment to the economy and to counter with arguments as to why the impediment is not of major

concern. All agree that at some level of effective rates the economic effects do become a major consideration. The goal in taxation of capital gains should be to provide the necessary revenue as equitably as possible with resulting economic effects that are consistent with the goals of the economy at the particular time. Complete absence of interference is not necessarily desirable. Judging from the performance of the economy in the United States in the past, the present degree of interference resulting from capital gains taxation has not been a severe handicap.

CHAPTER VI

ALTERNATIVE REFORM PROPOSALS

The appraisal of the relative merits of a tax depends on whether or not it results in equitable treatment of taxpayers; possesses desirable economic and social effects; produces the required amount of revenue; and, whether or not it is practical from the standpoint of compliance and administration. Students of capital gains taxation find that conflicts exist between each of these criteria. Deriving the maximum benefit from any one area automatically raises havoc with the other areas.

Efforts to devise a workable capital gains tax must result from a series of compromises. The combination of compromises which would produce the desired overall result has never been discovered, much less agreed on. The result has been a wide range of proposals for revision. At one extreme complete exemption of capital gains from tax is called for. At the other extreme it is suggested that capital gains and losses should be granted no special treatment, but taxed as ordinary income.

This chapter will review the major proposals for reform and several less significant proposals will be mentioned briefly. The purpose is not to provide a complete review of proposals, but to discuss those which appear to

have the potential of contributing to the rectification of the capital gains area in the near future.

Averaging of Income

A number of different averaging proposals have been put forth as solutions to the problems due to bunching of income in the year of realization. The scope of this paper does not allow a complete handling of averaging techniques but the presentation which follows should be sufficient as an indication of the type of relief that such devices could provide. The material here represents the more common approaches and proposals that would seem to have reasonable chance of being considered by Congress if the occasion should arise.

Each of the approaches assumes that capital gains and losses would be treated as ordinary income and that transfer of appreciated capital assets by gift or death would be treated as constructive realization of gain or loss. The approaches also incorporate the parallel treatment of capital gains with capital losses. These provisions are generally espoused as being necessary to the establishment of an averaging plan. On the other hand, each approach can be considered as either optional with the taxpayer or required of all taxpayers. Also, each proposal is capable of handling the taxation of unrealized

gains either annually or at the end of an arbitrarily determined period. Averaging can be implemented with or without provision for the taxation of unrealized capital gains.

Income Averaging Under the Present Law. The Revenue Act of 1964 provided a new averaging device which supercedes the special, limited averaging procedure formerly in the law (old Sections 1301-1307). The Act substituted provisions (new Sections 1301-1305)¹ which are available generally to any taxpayer.

Capital gains are excluded from the definition of averagable income under the present law. Although the matter has never been formally proposed, in the event that Congress should decide to provide some sort of averaging for capital gains, it would seem logical that the first thought would be to extend the present law to include capital gains. Considering the degree of complexity of the present averaging procedure, it would seem illogical, as well as impractical, for Congress to impose a distinctly different (and relatively complex) averaging method for capital gains. If averaging is desirable, the ideal approach would be to have one averaging device for all types

¹78 Stat. 105-112.

of income.

The new provisions permit averaging of all types of income except capital gains, wagering gains, income from gifts or bequests, and premature distributions received by owner-employees under a pension plan.² Only individual citizens or residents throughout the year can qualify for averaging.³ Corporations, estates and trusts are not eligible. Generally, averaging is not available to any individual who has very recently joined the ranks of taxpayers.⁴ In the event the adjusted taxable income of the current year exceeds 133 1/3 per cent of the average income⁵ for the preceding four years by more than \$3,000 averagable income results and, in effect, the averagable income is spread over the current and preceding four years. This is accomplished by adding 1/5 of the averagable income (only the excess of adjusted taxable income over 133 1/3 per cent of base period income) to the remaining or nonaveragable income (133 1/3 per cent of average base period income) and computing a tax. All averagable income

²Int. Rev. Code of 1954, Sec. 1302(b)(1).

³Int. Rev. Code of 1954, Sec. 1303(a).

⁴Int. Rev. Code of 1954, Sec. 1303(c)(1).

⁵As adjusted by rules set out in Int. Rev. Code of 1954, Sec. 1302(c).

is then removed from the base and a tax is computed solely for the nonaveragable income of the current year. The difference in the two taxes represents the tax due on 1/5 of the averagable income at the current year's rates. This difference is multiplied by 5 to find the total tax attributable to the averagable income. The sum of the taxes on averagable and nonaveragable income represents the tax liability for the current year.

Even from the general description given above the complications involved in this averaging system are evident. A more detailed explanation would reveal difficulties in determining eligibility and in the computation when, for example, capital gains are involved, the base period includes low-income or no-income years, or both joint and separate filings were made in the averaging period.

Proration of Capital Gains and Losses. Proration is an averaging method designed to give relief to a limited group of taxpayers with variable or bunched incomes. Just as averaging has many approaches, there are a number of ways to implement proration. One approach would be to spread realized capital gains or losses in equal-size installments either forward or backward over a period equal to the holding period of the asset or some arbitrary

period of time (5 or 10 years is commonly suggested). Under this form of proration the net realized capital gain or loss of the current year would be divided into equal parts (the number of parts would be dependent on the length of the proration period). The tax for each of the proration years then would be recomputed on the basis of ordinary income plus the prorated part of the realized gain or loss at the rates and exemptions applicable to each year. The tax applicable to a capital gain or the tax credit applicable to a capital loss would be the difference in taxes actually paid and the new tax liability determined after the inclusion of the prorated gains and losses.

Another proration method avoids the disadvantage of having the computation of tax liability dependent upon past or future incomes and tax rates. The capital gain or loss is spread over the period an asset was held (or an arbitrarily determined period) in order to arrive at an effective tax rate based only on tax rates, exemptions, and other income of the year of computation. This approach is similar to the one provided in the law⁶ which is described above as being applicable to income other than capital gains. The major difference is the reference

⁶Int. Rev. Code of 1954, Secs. 1301-1305.

of the present law to income for four prior years and the 133 1/3 per cent nonaveragable income. Under this method the computation involves dividing the total realized gain or loss by the chosen number of proration periods; computing the difference in the current year's tax resulting from the inclusion of one equal part of the gain or loss in taxable income; and multiplying the difference by the number of proration periods in order to arrive at the total tax or tax credit applicable to the gain or loss.

Simple or Periodic Average. Although it would be possible to apply simple averaging to a specific type of income such as capital gains or losses, the approach is designed to equalize the taxes of individuals with the same aggregate income for an arbitrarily determined averaging period (5 or 10 years is commonly suggested). At the end of each averaging period the taxpayer would recompute tax liability for the period as if the total income for the period had been received in equal installments. The taxpayer would be entitled to a tax credit in the event that the recomputed tax liability is less than the actual taxes paid annually during the period.

Cumulative or Progressive Average. As suggested by the use of the word cumulative in the title, this averaging

process is continuous over the averaging period. The averaging computation for the simple average is made at the end of a predetermined number of tax periods and only the periods within the averaging period are involved. This system requires an averaging computation at the end of each tax year (with the exception of the initial year) and all tax years from the point of inception are included in the average. For a given averaging period the simple and cumulative approaches would yield the same tax liability. The primary difference in the two methods is that the cumulative method would keep the taxpayer current with respect to tax liability, whereas, the periodic would not.

Cumulative averaging could be adapted for a specific type of income but is generally recommended as being made applicable to all types of income. Also, it could utilize an averaging period of any length, even from a taxpayer's first return until his final return. Again most suggestions have been for an averaging period of 5 or 10 years. In the first year of the chosen period a taxpayer would simply pay tax on the income received in that year. At the end of the second year of the period, the taxpayer would compute tax liability for the two years. After the second year's computation the taxpayer would pay or receive a refund for the difference in the actual tax paid in the

first year and the tax computed on average income. After each subsequent year of the period this procedure would be repeated.

Moving Average. The operation of a moving average would be similar to the cumulative average approach in that both would involve an annual computation and settlement. Each year's income has an effect on average income under the cumulative plan. Only the most recent years would make up the average under a moving average plan. The choice of the number of years to be included is generally five. Each year the current year's income is added and the earliest year's income is excluded. An averaging period might be the five most recent years (1962-1966) for the 1966 tax year computation. If so, the 1967 computation would include tax years 1963-1967. The effect of this plan is to tax income as if it had been earned ratably over the averaging period.

Advantages and Disadvantages of Averaging. The averaging plans described above would seem to provide a solution to the problems arising in connection with the taxation of fluctuating income from the realization of capital assets. Under any one of the plans two taxpayers with the same aggregate income over a given period would incur very similar (if not identical) tax liabilities.

The more equitable treatment of taxpayers would seem to be the strongest argument in support of averaging--the large majority of those who have reviewed these proposals have supported them. However, a dissenting view is presented by one authority, Wilbur Steger.⁷ His conclusions are noteworthy since they are partly based on an empirical study. He indicates that averaging systems generally reduce the effectiveness of the progressive tax structure because of the equalizing effect upon the distribution of income. Steger's study indicated that the reduced effectiveness would vary according to the specific averaging plan chosen, but could be as high as 20 per cent. Some other damaging arguments which he presents are:

- 1) A long averaging period is inconsistent with the period by which the majority of individuals conceive and plan their economic activity.
- 2) Many averaging systems are defective because taxes under the averaging system respond to current income only with a lag.
- 3) The prevention of changes in the progressive tax structure, as under certain averaging systems, is inequitable.⁸

⁷Wilbur A. Steger, "Averaging Income for Tax Purposes: A Statistical Study," National Tax Journal, IX (June, 1956), pp. 589-620.

⁸Ibid., p. 594.

Also, an averaging plan for realized gains and losses combined with the taxation of unrealized gains and losses, either periodically or at death or gift, would reduce the influence of timing on the disposition of capital assets and remove a major inducement for taxpayers to hold capital assets with accrued gains. The fact that capital gains and losses would be subject to the same rates as ordinary income would reduce substantially the myriads of problems (both legislative and judicial) associated with attempts to convert ordinary income into capital gains. At the same time sources of complexity in the law such as holding periods, percentage exclusions, maximum effective rate limitation, and limited income offsets for capital losses all would be eliminated. Problems surrounding allowances for depreciation would be mitigated and the complicated provisions involved with "recapture of depreciation" would be unnecessary; Sections 1245 and 1250 could be done away with. Averaging would also stabilize tax revenue to a large degree, thus facilitating fiscal planning.

Although there is no general agreement in this area Steger also believes that averaging combined with the full inclusion of capital gains and losses would have serious economic consequences. The reason given for this is that "the effective rate on capital gains would increase

severely, for all taxpayers, above the taxes paid under the current preferential treatment, averaging or not."⁹

On this point most proponents of averaging agree. Steger points out that averaging is not much relief from the impact of full inclusion. His estimate is that averaging would reduce the tax on capital gains by 5 per cent or less.¹⁰ He cites adverse economic effects such as: decreased mobility of capital assets, accentuated fluctuations in the price of capital assets, a long-run decline in the price of capital assets, reduced aggregate investment, and reduced investment in high risk assets.

A major problem with averaging is that it would raise difficulties of compliance and administration. It is generally thought that this would be a small price to pay for the increase in equity that would be obtained. It should be recalled that, although a degree of complexity is attendant to any averaging plan, the difficult provisions relating to the taxation of capital gains and losses of the present law mentioned above would be eliminated. The recent adoption of electronic data processing methods by the Internal Revenue Service in the processing

⁹Wilbur A. Steger, "Economic Consequences of Substantial Changes in the Method of Taxing Capital Gains and Losses," Tax Revision Compendium (Washington: United States Government Printing Office, 1959), vol. 2, p. 1265.

¹⁰Ibid., p. 1266.

of taxpayer returns should solve many of the administrative problems which formerly existed.

Experience indicates that the success of averaging depends partly on its practicability. Averaging experiments in Wisconsin and Australia were abandoned after a brief period. Practical considerations played a major part in the failure of these experiments.¹¹ Most students of taxation would agree that "the complexities are great, but basically arithmetical, as compared to the legal scheming that surrounds the capital gains tax."¹²

Some additional information is required by all of the averaging proposals. Proposals which involve "spread-back" may involve the reopening of prior year's returns or at least the availability of information from a number of prior years. Since it is undesirable to cause tax years on which the statute of limitations has run to be reopened and due to the fact that many taxpayers may not be able to locate their prior tax returns, averaging plans with these features present serious disadvantages. Averaging plans which do not require taxpayers to make computation

¹¹Report of the Wisconsin Tax Commission (Madison, Wisconsin, 1936) and Third Report of the Royal Commission on Taxation (1934), sec. XXXIV.

¹²J. B. C. Woods, "Taxation of Extraordinary Income," Taxes, vol. 33 (May, 1955), p. 365.

and settlement on an annual basis present a problem of collections which may be serious. Any widening of the gap between the time income is earned and the time when tax is due would seem undesirable. The experience of the State of Wisconsin's short-lived plan bears this out.¹³

Rollover Approach

A proposed solution to the capital gains dilemma is the so-called "rollover approach." It involves the deferral of tax on net realized rollover gains to the extent that the gains are reinvested in other rollover assets. Net realized rollover losses would be recognized in full in the year of realization regardless of reinvestment. In the event that a taxpayer realizes a rollover gain and fails to reinvest the proceeds the net unreinvested gain would be subject to tax as ordinary income. Several variations of this approach are possible but, except where otherwise indicated, this discussion is drawn from material presented before the Ways and Means Committee in 1958.¹⁴

¹³Report of the Wisconsin Tax Commission, op. cit.

¹⁴Statement of Reuben Clark, Hearings before the Committee on Ways and Means, (General Revision of the I.R.C.), 85th Congress, 2nd Sess., Part 2 (1958), pp. 2272-2281.

Assets Eligible. Although it would be possible to incorporate the present definition of capital assets into the rollover approach, rollover assets should be limited to property held for income production and not primarily for purposes of selling at a profit. The notable variance from the capital asset definition is that rollover assets would include depreciable property.

Taxpayers Eligible. In order to keep deferred tax on rollover gains from being postponed indefinitely, the proposal requires that the death of the taxpayer be treated as constructive realization. Since corporations have unlimited lives, the proposal allows deferral only to non-corporate taxpayers. It would be possible, however, to allow corporations rollover treatment for depreciable property.

Reinvested Gains. As indicated, the net realized rollover gains are to be deferred to the extent of reinvestment in qualified rollover assets. The cost basis of the new property acquired as reinvestment would be reduced on a pro rata basis by the amount of the gain currently not recognized. If total purchases for the year exceed the total sales for the year, any realized gain from qualified assets must have been reinvested and no current tax liability would result.

Non-Reinvested Gains. In the event that sales of rollover assets exceed purchases for the year, any resulting gain would either be wholly or partly taxable as ordinary income. If the gain is less than the net reduction in qualified assets, the entire gain would be taxed as ordinary income. When the gain is equal to or greater than the net reduction in qualified assets, the recognized gain would be limited to the amount of the reduction with the remainder serving as a reduction of the cost basis of the new property acquired.

Realized Losses. The proposal provides for a current deduction against ordinary income where transactions in rollover assets results in a net loss. This would be true regardless of whether the taxpayer increased or decreased his investment in rollover assets. In addition, it is suggested that very liberal treatment be allowed for ordinary loss carryovers.

Death of Taxpayer. An important facet of the rollover proposal is that the death of the taxpayer must constitute a constructive realization of any deferred gain on property which is held at time of death. Otherwise the rollover plan becomes an exemption plan. In addition to the recognition of realized gains that had been deferred, it is suggested that all unrealized gain become subject to

tax at death. Problems created by the bunching of income that may result would be handled through the extension of income averaging to rollover gains and a provision for the extension of time for payment of tax similar to that allowed for the estate tax where a closely held business is involved.¹⁵

Holding Period. No holding period would be required with respect to rollover assets.

Year-end Adjustments. The determination of the net gain or loss from rollover assets is to be made on the basis of a conventional tax year. Since the recognition of a net gain would be dependent on reinvestment, taxpayers disposing of rollover assets near the end of a tax year would need some grace period after the year ends within which they could make qualified reinvestments. A period of thirty or sixty days is suggested.

Advantages. The primary advantage of this proposal is that it would contribute to a better allocation of investment funds by eliminating the immediate tax consequences of disposing of appreciated investments. In

¹⁵Small Business Tax Revision Act of 1958, 72 Stat. 1681.

addition, it would take away the present incentive to hold appreciated property until death in order to escape income taxation.

The proposal would largely neutralize the differential that exists between the treatment of capital gains and other income. The reduced incentive to achieve the preferential treatment would ease the all-out effort to seek or create loopholes to transform ordinary income into capital gains.

Equity would be facilitated. Not only would the treatment of taxpayers with the same amounts of income be brought into closer harmony, but also the differences in the tax impact for individuals at various income levels would be mitigated.

Disadvantages. The major problem in the implementation of the rollover approach is complexity. Mr. Clark states a contrary opinion ". . . it would be both administratively feasible and relatively simple in practice."¹⁶ Dan Throop Smith indicates that "It would, however, make the law more complicated; perhaps it would not be administratively feasible."¹⁷ The reporting and administrative

¹⁶Reuben Clark, "An Alternative to Capital Gains Taxation: A 'Rollover' Account for Investment Assets," Howard Law Journal, vol. 4 (June, 1958), p. 161.

¹⁷Dan T. Smith, Federal Tax Reform (New York: McGraw-Hill Book Company, Inc., 1961), p. 152.

problems are not insuperable; however, they are significant enough to present a real limitation.

The impact of such a proposal on revenue has not been estimated. Obviously, the loss relative to the contribution of the capital gains tax would be a major factor to consider.

Variations. The rollover proposal can be applied to gains and losses from any group of assets. To minimize problems in transition it may be desirable to equate the present capital asset with the rollover asset. Or it may be desirable, at least initially, to limit qualified assets to corporate securities. Ideally the definition should be made to encompass only "true" capital assets.

As an alternative to recognition of all rollover gains (both realized and unrealized) at point of death, the proposal could recognize only the realized portion. The result would be similar to the present law. Of course the incentive not to realize gains but to hold property until death would remain. Another variation would be to tax the unrealized portion through a special estate tax.¹⁸ The "carryover of basis" for property transferred at

¹⁸Federal Income Tax Treatment of Capital Gains and Losses (Washington: United States Treasury Department, 1951), p. 77.

death is another possibility. The basis in the hands of the decedent would become the basis of the property in the hands of the decedent's heirs.¹⁹

Taxation of Transfers at Death and by Gift

Constructive Realization. The proposal to tax capital gains at the point of transfer at death and by gift has been mentioned in this chapter as a counterpart to various other proposals. In that context the unrealized gain was to be recognized at death or by gift and included in income to be taxed at full progressive rates. Here it is independently considered as a reform measure with the retention of preferential treatment. The description of the proposal will follow the form outlined by the President in January, 1963²⁰ and discussed in more detail by the Secretary of the Treasury.²¹ The fact that the Administration has suggested this proposal makes it important from a

¹⁹Richard Katcher, "A Critique of Capital Gains Taxation Problems and Proposals," 1962 Southern California Tax Institute (New York: Matthew Bender & Company, 1962), p. 790.

²⁰Message from the President of the United States, "Hearings Before the Committee on Ways and Means, 88th Cong., 1st Sess., Part 1 (1963), pp. 23-26.

²¹"Technical Implementation of the President's Recommendations Contained in his Message on Taxation," Hearings Before the Committee on Ways and Means, 88th Cong., 1st Sess., Part 1 (1963), pp. 128-137.

practical viewpoint even though it did not become a part of the House bill. Although this is not a comprehensive measure, it would constitute a move in the right direction and tend toward equality of taxation not only among those with the same amount of income from different sources but also among those whose income is mainly capital gains. It is true that this proposal would not eliminate the advantage in the postponement of realization, but it would do away with the more powerful advantage of complete exemption from the income tax.

The present law does not provide for taxation of gains or losses resulting from the disposition of property by gift or at death. In the case of gifts, generally the basis of the property in the hands of the donor becomes the basis to the donee.²² Under this proposal, the donor would be taxed on appreciation up to the point of gift and the donee would then receive the property with a basis as the fair market value at the date of gift. Presently, in the event of death, the beneficiary receives property of the decedent with a basis equal to the valuation used for estate tax purposes.²³ The result being that appreciation of property while in the hands of the decedent is not

²²Int. Rev. Code of 1954, Sec. 1015(a).

²³Int. Rev. Code of 1954, Sec. 1014.

subject to income tax. This proposal would place a tax on the unrealized gain on property held at time of death.

This proposal calls for constructive realization of gains and losses when capital assets are donated or transferred at death. The valuation used for estate tax purposes would be used to determine the capital gain or loss in the decedent's final income tax return. The resulting gains or losses would be taxed at the normal capital gains rates (for purposes of the President's proposal the inclusion percentage was to be reduced from 50 per cent to 30 per cent). Since the bunching of income would obviously occur under this plan the averaging provisions of Sections 1301-1305 (described in the section of this chapter on averaging) would be extended to include capital gains. Related special provisions include a three-year capital loss carryback, an exemption for the first \$15,000 of gain involved, a marital exclusion which would operate like the marital deduction, permanent exemption for charitable bequests, and an arrangement which would permit up to 10 years to pay the estate tax.

Lifetime gifts would be treated essentially the same as any other sale or exchange of capital assets. Completed gifts (if the property would not be included in the gross estate for estate tax purposes) involving gains would be subject to the normal capital gains treatment. In the

case of a loss, no change would be made and the usual rules would apply. Special provisions would include an exception for charitable gifts, a marital exclusion, and an exemption of the first \$15,000 of gain (one exemption would be applicable to transfers by gift and at death).

A number of different capital gains reform measures which employ the taxation of gift or death transfers are possible. The combination of this proposal with various averaging methods has already been mentioned. In connection with the rollover proposal, tax could be imposed at the point of death on all gains, whether or not realized, with a spread-back provision to alleviate the bunching problem. Also with rollover, it would be possible to tax at death only the previously realized but untaxed gains leaving the unrealized gains, as at present, not subject to income tax. Another approach would be to solve the problem with an additional estate tax based on the portion of the decedent's property which constitutes unrealized gain. In the event that an income tax on unrealized gains is held to be unconstitutional, one author suggests yet another alternative, that of imposing an excise tax on the accrued gains at the same rates and in combination with the taxes on ordinary income.²⁴ All of the approaches

²⁴Lawrence H. Seltzer, *The Nature and Tax Treatment of Capital Gains and Losses* (New York: National Bureau of

to taxing unrealized gains at gift or death are open for variation of applicable rates and even as to the type of assets to be included. According to one's view of what is appropriate, rates could be the same as the preferential ones now in effect, those applicable to other income, or set at any other level. The definition of capital assets for this purpose could be broad or narrow according to one's purpose and what seems practical. Also, there is no reason why the proposal could not be altered to include either transfer by gift or at death, and not necessarily both. It would appear that parallel treatment would be desirable but not required.

In support of the constitutionality of the President's proposal, Secretary of Treasury Dillon submitted an opinion prepared by the General Council of the Treasury.²⁵ The opinion points out that Federal courts should give a liberal construction to the Congressional power to tax by recognizing its broad discretion to define income. With respect to Eisner v. Macomber,²⁶ in which the Supreme

Economic Research, Inc., 1951), p. 302.

²⁵"Opinion of the General Council of the Treasury," Hearings Before the Committee on Ways and Means, 88th Cong., 1st Sess., Part 1 (1963), pp. 592-598.

²⁶252 U. S. 189 (1920).

Court ruled unconstitutional an attempt to tax stock dividends and defined income so as to exclude unrealized gains, the case is not an obstacle to the proposed legislation. "Later Supreme Court cases have so modified and qualified its concepts that there is every probability that the Supreme Court will now recognize power in Congress to tax appreciation in value as income at appropriate times."²⁷ Referring to the definition of income set out in Macomber, "the proposed legislation is not inconsistent with the foregoing definition as it proposes to tax as income 'something of exchangeable value' that is 'drawn by' the taxpayer for his 'disposal.' The increase in value, having an exchangeable value, would be disposed of by the taxpayer according to his wishes to accomplish his economic objectives."²⁸

The implementation of this proposal would be very favorable from the equity standpoint. The present discrimination which exists between taxpayers who choose to realize their gains during life and those who hold appreciated property until death would be eliminated. Also the ability of taxpayers to postpone tax through gifts

²⁷"Opinion of the General Council of the Treasury," op. cit., p. 593.

²⁸Ibid.

(in extreme cases postponement can continue for several generations) would be curtailed. It is estimated that gains which pass untaxed between generations are as much as \$12 or \$13 billion each year.²⁹ Not only would equity be facilitated but this also represents a tremendous untapped source of revenue. The result of imposing a tax on these unrealized gains would be to significantly lessen the incentive to hold appreciated assets (the so-called locked-in effect) thus providing for a much more natural flow of investment.

One authority refers to the present opportunity for reducing personal income tax by realizing all capital losses and retaining until death all appreciated capital assets as "the most serious single fault in our income tax system."³⁰ The same authority indicates that correction of this would disrupt the significant evasion of tax due to undistributed corporate earnings. The proposal would ensure that stockholders would ultimately be taxed on their pro rata shares of reinvested corporate profits.

Continued adherence to the realization principle is supported by the fact that it is traditional, common in

²⁹Hearings Before the Senate Finance Committee
(on the Revenue Act of 1963), 88th Cong. 1st Sess., Part 1
p. 307.

³⁰Henry C. Simons, Personal Income Taxation (Chicago:
The University of Chicago Press, 1938), p. 164.

business usage, and largely coincides with accounting treatment. Departure from realization creates additional problems of valuation and basis determination. Where transfers are large enough to require valuation under present law no additional problems arise, however. Such a proposal (even with the exemption of the first \$15,000 of gain) would create new valuation problems. Also, whereas presently no basis need be determined for a decedent's assets, basis would be required under this proposal since transfers would be realizations. This would create difficulties where the assets had been owned for a long period of time or where the records of the decedent were incomplete or nonexistent.

Another problem has to do with the increased liquidity which would be demanded under the proposal. Even with an averaging plan and liberal terms for payment of tax where a closely held business is concerned, estates may be forced to liquidate assets. This may not be desirable from a social or economic standpoint. The liquidity problem would be minimized under the President's proposal due to decreased percentage inclusion, lower rates, averaging, and the liberal payment terms. The problem would be much greater under other proposals which would apply the full progressive rates that are applicable to other income.

Although this proposal would eliminate the possibility of complete exemption from capital gains tax, it would not do away with the advantage to be gained by postponement of tax by retaining the asset until death. The advantage would be countered by the liquidity problems which may arise by holding appreciated property until death. Thus tax planning may dictate that gains be recognized, at least partly, at certain intervals during life so as to alleviate the liquidity problem at death.

Transfer of Basis. Due primarily to the problems of constitutionality and the ability-to-make-payment, an alternative to constructive realization has been proposed. This approach involves a carryover of the decedent's basis to his heirs. The procedure would be similar to that provided in the present law for gifts (Section 1015 described above). Heirs would compute capital gain or loss on disposition of inherited assets by referring to the basis of the decedent as adjusted for any tax paid on the appreciation in value during the decedent's lifetime.

This approach is particularly noteworthy since the House Ways and Means Committee substituted it for the President's constructive realization plan in drafting the Revenue Act of 1963.³¹ The plan approved by the Committee

³¹Congressional Quarterly Weekly Report (Washington:

called for certain modifications such as the exclusion of the first \$60,000 of all estates and a \$15,000 exemption for those estates which would come under the basis carry-over provisions. Only estates of persons dying after December 31, 1964 were to be subject to the new provisions and the carryover would apply only to assets purchased after January 1, 1951.³² The Committee later reversed its decision and eliminated this section of the tax bill. The action came when the Committee could not agree on the legal language of the section.³³ The Administration seemed to have been willing to go along with the carryover of basis provisions inasmuch as the Secretary of the Treasury referred to the tentative provision as "reasonably satisfactory."³⁴

This approach would completely avoid the constitutional consideration and mitigate liquidity problems that arise under constructive realization. It would restore consistency to the treatment of transfers by gift and at

Congressional Quarterly Inc., 1963), XXI (Week ending June 7, 1963), p. 936.

³²Ibid., (Week ending August 16, 1963), p. 1443.

³³Ibid., (Week ending August 30, 1963), p. 1517.

³⁴Hearings Before the Senate Finance Committee (on the Revenue Act of 1963), 88th Cong., 1st Sess., Part 1, p. 145.

death and curb tax postponement by removing the possibility of escaping the income tax on capital gains at gift or death. Also, it would aggravate the locked-in effects on investment. Technical complications could be held to minor proportions by the adoption of provisions which would make the carryover apply only to recently acquired assets and to relatively large estates. Seltzer points out that allowing the transfer of basis departs from the principle of a personal income tax.³⁵ Congress has found no objection to this in the case of inter vivos gifts.

Accrual Basis

This proposal departs from the "realization principle" which is traditional in income tax procedure. It calls for the full annual recognition of both accrued and realized capital gains and losses. Each year taxpayers would be required to include in or exclude from taxable income the net accrued gain or loss on capital assets owned, whether or not such gain or loss had been realized.³⁶ Usually this approach contemplates the taxation of capital gains at the same progressive rates that are applicable to

³⁵Seltzer, op. cit., p. 303.

³⁶Proceedings, Ninth Annual Conference, (New York: National Tax Association, 1915), pp. 303-5 and Facing the Tax Problem (New York: Twentieth Century Fund, 1937), pp. 490-1.

ordinary income along with the full offset of accrued capital losses against ordinary income. Other variations, such as a periodic inclusion of accrued gains and losses with simple averaging over a set period, are possible. Another possibility would be to vary the definition of assets subject to accrual treatment; for example, a narrow definition might require this handling for listed securities only. Generally the approach that is suggested includes all capital assets under the present definition.

The approach would require an inventory of capital assets owned at the beginning and end of each tax year. The net change in the value of the inventory would be taken into account as the final settlement of the tentative tax adjustments previously made on the accrual basis. In order to avoid the adverse effects of the bunching of gains or losses due to fluctuations in annual accruals, the proposal would include an income averaging plan. Just as the realization approach results in the bunching of gains and losses, the same problem (generally of much lesser proportions) would result from use of the accrual basis. Perhaps the simplest solution to this problem would be the allowance of generous carryforwards and carrybacks of net capital losses (another form of averaging).

No specific recommendation has been made on how to

handle past unrealized gains and losses which would exist as of the effective date for an annual accrual plan. A number of methods for dealing with the problem appear. Past accruals could be ignored with all property acquiring a new basis at the starting date; all gains and losses accrued in the past could be recognized in the first year of the operation of the new system; a special averaging plan could apply to the previously accrued gains or losses; or, the prior accruals could be deferred until realization. A form of initial recognition with averaging would appear to be the most equitable method.

The implementation of a tax on unrealized gains has been discounted since it was thought to have constitutional difficulties.³⁷ The realization principle was enunciated by the Supreme Court in the Macomber Case³⁸ and this clearly indicates that an accrual method would be unconstitutional. Presently, however, the chances of an accrual method being upheld are much improved as indicated by testimony before the House Ways and Means Committee in connection with the taxation of capital gains (unrealized) at point of transfer by gift or death.³⁹ The opinion

³⁷ Ibid.

³⁸ Eisner v. Macomber, 252 U. S. 189 (1920).

³⁹ "Opinion of the General Council of the Treasury," op. cit., pp. 592-598.

is not directed toward a complete accrual basis but the reasoning given indicates that subsequent decisions have impaired the authority of the Macomber Case. Other authorities⁴⁰ agree with this favorable opinion where transfer by donation or death is involved. This would seem to be just one step removed from a complete accrual basis. For a more detailed discussion of this opinion, refer to the section above on constructive realization at gift or death.

The accrual basis proposal is intended to offer uniformity and equity to recipients of capital gain and loss as well as ordinary income and loss. It would eliminate the existing possibilities for avoidance and postponement of the capital gains tax. On the one hand, difficult problems of compliance and administration are opened; however, it would eliminate problem areas created by present provisions for holding period; percentage exclusion, maximum alternative rates, and loss limitations. Tax free shifts of investments would be possible under this approach and incentives to hold appreciated property would

⁴⁰Harold M. Groves, Production, Jobs and Taxes (New York: McGraw-Hill Book Company, Inc., 1944), p. 75; William Vickrey, Agenda for Progressive Taxation (New York: Ronald Press, 1947), pp. 140-1; and Randolph E. Paul, Taxation for Prosperity (New York: The Bobbs-Merrill Company, 1947), p. 275.

disappear.

The primary disadvantage of this approach is indicated by this quotation from a noted tax authority: "Outright abandonment of the realization criterion would be utter folly; no workable scheme can require that taxpayers reappraise and report all their assets annually. . . ." ⁴¹ Certainly for many types of assets accurate appraisal is difficult and a broad definition of capital assets may be unworkable under this plan. Partially alleviating the valuation problem, as pointed out by Professor Shoup, ⁴² is the fact that interim errors are not so serious since a final reckoning must occur at the point of realization. Another adverse effect of taxing unrealized gains is the lack of funds on the part of some taxpayers to meet their current tax liabilities. The owners of rapidly appreciating property would be required to either realize a portion of their accrued gains or be forced to pay their taxes from other income or with borrowed funds. The implementation of accrual basis indicates some adverse economic effects arising due to an increase in the effective rate of tax for capital gains.

⁴¹Simons, op. cit., p. 207.

⁴²Capital Gains Taxation (New York: Tax Institute Incorporated, 1946), p. 26.

A general reduction in the ordinary income-tax rates presumably would offset these effects.

Other Proposals

This section will mention briefly other less significant approaches to reforming the capital gains provisions.

Rationalization. This proposal calls for a careful review of the entire area of capital gains taxation with a view toward eliminating transactions and receipts which are not true capital gains. Many incomes currently receiving capital gains treatment (such as, distributions from retirement plans, stock options, patent royalties, coal royalties, cutting of timber, and livestock) would be subject to ordinary income treatment. The President's recommended tax legislation in 1963 included structural changes to correct these areas.⁴³ The difficulty with this approach lies in trying to distinguish between true capital gains and other income. However, some items presently receiving preferential treatment are clearly outside the scope intended for preferential treatment.⁴⁴

⁴³"Message from the President of the United States," op. cit., pp. 22-25.

⁴⁴Stanley Surrey, "Definitional Problems in Capital Gains Taxation," Tax Revision Compendium (Washington:

Other more comprehensive proposals include a suggestion for rationalizing capital gains as an integral part of reform.

Step-Scale Reduction in Tax Rates. Another proposal is to provide for a graduated reduction in tax rates applicable to realized capital gains based on the length of time an asset was held prior to disposition. Such a plan has received little attention since World War II but was actually a part of the capital gains law from 1938 to 1942 (see the chapter on history). This plan would reduce the incentive to convert ordinary income into capital gains but would, on the other hand, increase the incentive to hold appreciated capital assets. Tax computations would be more complicated under the plan due to the various rates that may be applicable.

Elimination of Preferential Treatment. Some authorities such as Harold Groves have recommended that preferential treatment for capital gains and losses be eliminated.⁴⁵ Parallel treatment of all income would be

United States Government Printing Office, 1959), vol. 2, pp. 1203-1232.

⁴⁵ Groves, op. cit., p. 79. See also Henry C. Simons, Federal Tax Reform (Chicago: The University of Chicago Press, 1950), pp. 55-56.

accompanied with an adequate averaging plan and the reduction of the personal surtax rates. Arguments for this method would be its simplicity, equity, and the fact that losses would be allowed unconditionally. It would, however, tend to increase the effective rates applicable to capital gains (with its possible adverse effects on investment) and accentuate the problem of double taxation on reinvested corporate earnings. Groves suggested advance payment on undistributed earnings by the corporation with a corresponding credit to the individual at realization as a means of dealing with undistributed earnings.⁴⁶

Elimination of the Unreal Element in Capital Gains and Losses. Included in a proposal by Donald Corbin⁴⁷ is an approach which would eliminate any unreal element involved in computation of capital gain or loss which was caused by changes in the general price level. The approach is sometimes used in conjunction with the full inclusion of capital gains in terms of real income. The aim is to do away with the inequity which arises from the taxing of unreal gains. The correction consists of adjusting the cost basis by means of an index number before calculating

⁴⁶Groves, op. cit., p. 81.

⁴⁷Donald A. Corbin, "New Proposals for Capital Gains Taxation," Taxes, vol. 34 (October, 1956), p. 665.

the gain or loss. A number of problems arise when indexes are introduced. As Henry Simons points out⁴⁸ when the price level is rising investors who break even or have nominal gains must be allowed to show a loss and when the price level is falling investors who break even or have nominal losses must be required to show a gain. Simons further points out that in a period of rising prices a person who disposed of capital assets would be favored over one who continued to use them in his business. For equity purposes he points out the latter should be allowed to write up his assets for depreciation purposes.

⁴⁸Simons, Personal Income Taxation, op. cit., pp. 155-6.

CHAPTER VII

SUMMARY AND CONCLUSIONS

Congress has always considered capital gains and losses to be within the scope of taxable income and indications are that they will continue to be considered as such for many years to come. The trend of recent legislation and proposals by the Johnson Administration indicate that any changes in the near future will be in the direction of more stringent taxation for capital gains and losses. The present law in this area has developed without Congress displaying any consistent policy as to how capital gains and losses should be taxed. The law has come about in a piecemeal fashion and is the result of a continuous process of experimentation and compromise.

Due to the nature of capital gains and losses and as a result of the absence of a consistent philosophy toward them on the part of Congress, this area of the income tax law abounds with complexities and inequities. It results in more unsatisfactory situations than any other single area of the Code. The most recent actions of Congress have, on balance, not improved the total situation. While recapture depreciation eliminated a grave inequity, this has been counterbalanced by the broadening of the definition of capital assets.

Problems dealing with the taxation of capital transactions are not confined to the boundaries of the United States. That other major countries are dissatisfied with their systems is evidenced by the number of significant changes that have been made in recent years. The recent changes made by Great Britain (by far the most radical), combined with changes made in other countries, indicate a trend of patterning foreign systems for taxing capital gains and losses after the United States' system. The methods for treating capital gains and losses in major foreign countries generally involve complexities and inequities that are comparable to those found in the United States' system.

The major conclusion of the study is that capital gains and losses should be included in full in taxable income at the point of realization. Gains and losses from sales or exchanges of capital assets fall within income broadly defined and a substantial portion of them are included even in narrow definitions of income. Also, with respect to taxpaying capacity and economic function they are indistinguishable from other types of income.

As a means of implementing the full inclusion of capital gains and losses the author proposes the measures listed below. The measures represent the complete revision of the approach to capital gains taxation that is

necessary in order to produce a system that is as simple as possible from the standpoint of reporting and administration while yielding a tax that is equitable and that produces a minimum amount of interference to the natural course of the economy.

1. Tax rate discrimination between capital gains and other types of income should be eliminated. Both capital gains and capital losses should be taken into account fully in computing taxable income subject to the ordinary progressive rate structure. Policy in this area should be based on one of the first principles of equity in taxation: "Don't tax income with personal exemptions and graduated rates unless you are prepared to tax it all."¹

2. The definition for the realization of capital assets should be broadened to include transfers by gift and at death. The present escape route is the greatest source of inequity in the capital gains area and is the primary cause of the "locked-in" effect on investment.

3. With the broadening of the tax base as a result of the first two measures it will be necessary to lower

¹Harold M. Groves, "Taxation of Capital Gains," Tax Revision Compendium (Washington: United States Government Printing Office, 1959), vol. 2, p. 1201.

the present progressive tax rates to the point where the average effective rate remains unchanged. The result will be a shifting of the tax burden toward the higher income taxpayers while the total revenue from the capital gains tax will remain approximately the same. Another principle of equity that should be closely adhered to is ". . . don't set the scale so high and the graduation so steep that you are not prepared to apply it consistently."² The present rates are obviously too high for Congress is not willing to allow them to apply in full to any taxpayer. Granting favorable treatment to certain types of income or taxpayers is not a suitable substitute for a general rate reduction.

4. Provide for proration of capital gains and losses over a period of five years or the holding period of the asset whichever is the shorter. This should be accomplished by a rebracketing system whereby the applicable rates are determined by the current year (similar to the present income averaging applicable to other income). This will avoid the reopening of prior years' returns and the recomputation of the tax for each year involved. Proration is the only special treatment that can be

²Ibid.

justified on a rational basis for capital gains and losses. This approach is necessary to avoid the problem of lumping in one year income accrued over a number of years.

5. Lenient terms should be provided for the payment of tax incurred by reason of capital gains realized at death. These terms should be available only where it can be shown that payment of the tax would result in an undue hardship on the estate.

6. Provide exemptions from the capital gains tax for such things as personal automobiles, private residences, personal property (where proceeds from sale are less than say \$500), gifts (below a minimum value of say \$3,000 per year) and estates (where gross estate is less than \$60,000). Care should be taken to extend tax relief in special situations only where there is clear proof that it serves the public interest. The exemptions suggested above are primarily to avoid problems of reporting and administration where transactions tend to be numerous and amounts of gain or loss small. At the same time the exemptions suggested would benefit the smaller taxpayer.

Comparable changes should be made for corporate taxpayers, that is, preferential rates should be eliminated and the overall rates lowered so that the tax revenue yield from corporate capital gains transactions remains

approximately the same. Also, since corporations are not subject to progressive rates, proration will either be inapplicable or where applicable will be applied in modified form. Provisions comparable to the present ones relating to tax-free exchanges and reorganizations would continue to be necessary.

The reform approach outlined above is not without opponents. Precedents and political expediency will provide the largest obstacles that must be overcome. This must be done through continued research but primarily by making the molders of tax policy aware of the nature of capital gains and losses and the part that they should play in the income tax system. If agreement cannot be reached on this fundamental reform measure, there are still possibilities for making worthwhile improvements in capital gains taxation. The most urgently needed measure is to provide for the taxation of capital gains at the point of transfer by gift or at death. This relatively simple step would do more to facilitate equity and to eliminate economic interference than any other single measure. Indications are that major reform will be slow in coming about but that the problems created by the gift and death situation will be eliminated by Congress in the near future.

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VITA

Donald Charles Marshall, the son of Henry Smith and Lula Marshall, was born in Beaumont, Texas on September 7, 1936.

He received his elementary and secondary education in the South Park Independent School System in Beaumont, Texas and was graduated from South Park High School in 1954. In 1958 he received the degree of Bachelor of Business Administration from Lamar State College of Technology and in 1964 the degree of Master of Science from Louisiana State University. His area of concentration in both degree programs was accounting.

From 1958 until 1963 he was actively engaged in the public accounting field during which time he acquired his certificate as a Certified Public Accountant. He taught two years on the staff of Louisiana State University on a part-time basis and is now an Assistant Professor of Accounting at the University of Missouri.

He married Margaret Ann Benton, also of Beaumont, Texas, on August 27, 1959. They have three children: Melissa Ann, age 5; Katherine Elaine, age 4; and Steven Michael, age 3.

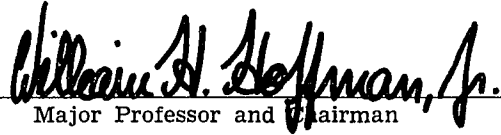
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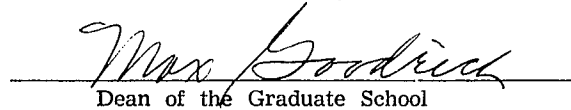
Candidate: Donald Charles Marshall

Major Field: Accounting

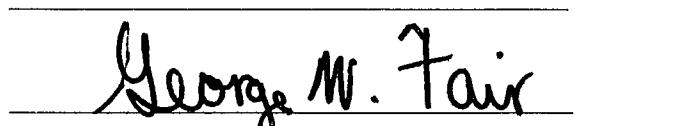
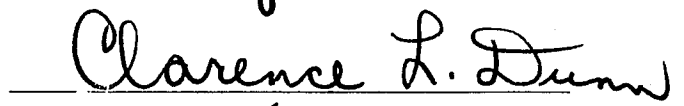


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